# The definition and regulation of state aids in EC law and subsidies in WTO law : a comparative analysis

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PhD thesis

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## Declaration

London, 27th July 2006

I declare that the work presented in this thesis is my own.

Mr Luca Rubini

# Abstract

The Chairman of a Roundtable on Subsidies and State Aid held at the OECD in 2001 concluded the proceedings noting that

> [t]he major problem identified is the issue of the definition – not just the definition of a subsidy but also the question of how to determine what is legitimate and what is not legitimate.

The 'issue of the definition' thus intended, which includes both the notion of subsidy and the regulation determining what effects are acceptable and what are not, represents the research topic. The thesis attempts to identify what is the best way to regulate public subsidies at an international level.

This is done through a comparison between WTO and EC law which constitute the two most developed international systems of control of subsidies.

Despite being a legal analysis, the writer draws from other disciplines, such as economics, political science and regulation.

After an introduction outlining the research scope and methodology, the thesis analyses the four main essential elements, the 'formants', of the definition of public subsidies (public intervention, advantage, beneficiaries and effects).

The recurring theme is the need to properly consider the interplay between the distortions of competition of subsidies and the public policy objectives they pursue. Legally, this requires an appropriate definition of what is scope and what is justification. Related issues concern i) the increasing role played by economic analysis between the needs to devise a sound regulation and to preserve legal certainty, and ii) the importance of institutional and procedural systems of control of public subsidies and their interplay with the substantive regulation.

The main, general finding of the research is that, against a paradigm optimal regulation of subsidies, each system has its strengths and weaknesses. Most importantly, both systems can be improved through a process of cross-fertilization, by learning something from the other.

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Ai miei genitori

Senza i loro sacrifici, e il loro supporto continuo e paziente,

nemmeno una parola di questa tesi avrebbe visto la luce.

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# GATT/WTO

'Tokyo Subsidy Code'
WTO Agreement
Agreement on Subsidies and Countervailing Measures ('SCM Agreement')
Agreement on Agriculture ('AoA')
General Agreement on Trade and Tariffs ('GATT')
General Agreement on Services ('GATS')

## Various GATT reports (in chronological order)


Working Party, Report on 'Other barriers to trade', adopted on 3 March 1955, BISD 3rd Supp., 1955, 222

Group of Experts, Report on 'Anti-dumping and countervailing duties', adopted on 13 May 1959, BISD 8th Supp., 1960, 145

Working Party, Report on 'Provisions of Article XVI:4', adopted on 19 November 1960, BISD, 9th Supp, 185

Panel, Report on 'Review pursuant to Article XVI:5', adopted on 24 May 1960, BISD, 9th Supp, 188

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Panel, Report on 'Operation of the provisions of Article XVI', adopted on 21 November 1961, BISD 10th Supp., 1962, 201

Committee on Subsidies and Countervailing Measures, Report, BISD 33rd Supp., 1986, 197

# Chapter 1
# Scope and methodology of the research

> 'Probe everything and keep the best' (Paul, *First Epistle to the Thessalonians*) [1]
>
> '... The British don't know how to make a good cup of coffee. You don't know how to make a good cup of tea. It's an even swap.' (From the *Instructions for American Servicemen In Britain 1942*)

## I. Scope of the research

The Chairman of a Roundtable on Subsidies and State Aid which was held by the Committee on Competition Policy in February 2001 concluded the proceedings by 'noting that the discussion has raised more questions than answers.' [2] Interestingly,

> [t]he major problem identified is the issue of the definition – not just the definition of a subsidy but also the question of how to determine what is legitimate and what is not legitimate. [3]

The 'issue of the definition' thus intended, which includes both the notion of subsidy and the regulation determining what effects are acceptable and what are not, represents the research topic of this thesis.

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[1] This evocative sentence has been the title of a lecture on comparative law given by Professor Markesinis in at the Faculty of Law of the University of Leicester on 24th November 2005.
[2] OECD (2001: 179).
[3] Ibid.

## 1. Brief background notes: subsidies and their history

Bounties, subsidies or aids have always been granted to undertakings. Different ways of reacting or controlling them have been devised. Similarly, different views have surrounded both subsidies and their regulation. These issues have been touched by the likes of Adam Smith and Alexander Hamilton. In his famous *An Inquiry into the Nature and Causes of the Wealth of Nations* Smith devoted a whole chapter on 'bounties'. He concluded that

> [T]he effect of bounties, like that of all the other expedients of the mercantile system, can only be to force the trade of a country into a channel much less advantageous than that in which it would naturally run of its own accord. [4]

This masterly explains the inefficiency, in the form of misallocation of resources, caused by subsidies, issue which we analyse in chapter 5.

It is also worth quoting a passage of Hamilton drawn from his 1791 *Report on Manufacturers* (and reported by Jackson (1997: 417)), which introduces other interesting elements:

> [T]he greatest obstacle of all to the successful prosecution of a new branch of industry in a country, in which it was before unknown, consists, as far as the instances apply, in the bounties premiums and other aids which are granted, in a variety of cases, by the nations, in which the establishments to be imitated, are previously introduced. It is well know ... that certain nations grant bounties on the exportation of particular commodities, to enable their own workmen to under sell and supplant all competitors, in the country to which the commodities are sent. Hence the undertakers of a new manufacture have to contend not only with the natural disadvantages of a new undertaking, but will the gratuities and enumerations which other government bestow. To be enabled to contend with success, it is evident that interference and aid of their own governments is indispensable.

What is interesting in reading this excerpt is that it touches with both the crucial issues in the area, the question of 'bounties and other aids' and the question of the

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[4] Smith (1776: book IV, chapter 5).

possible, in his words 'indispensable', counter-reactions to them, ie 'the interference and aid of their own governments'. Among remedies, the most natural means to restore the playing field has been that of granting subsidies to the aggrieved industry. [5] Another idea that has soon gained success was that of imposing on foreign imports benefiting from subsidies a duty to countervail the subsidy. More ambitious projects about creating international obligations regulating the grant of subsidies themselves, and some forms in international control, needed more time, and more global (historical, political and legal) changes, to emerge.

International treaties increasingly tackled the issue of subsidies, mainly referring to the use of countervailing duties. In 1923, in his famous work on dumping (since the beginning, in consideration of the similar effects, this term has included both dumping and subsidization), Viner (1966: 166-168) counted twenty-nine treaties containing rules on subsidies, of which seven were signed after 1900.

A crucial one was the Brussels Sugar Convention of 1902 which introduced rules to curb export bounties on sugar. It is not necessary to recall to the reader how support to sugar is currently particularly topical in WTO. The significance of the Brussels Sugar Convention goes well beyond this specific subsidy aspect. In the recent words of Moura Filho (2006: 1), through it 'multilateralism had been established as a conceptual alternative and a practical possibility'. This, just before the outbreak of WWI in 1914 and the subsequent period of protectionism which would have culminated with WWII in 1939. Only thereafter, the idea of multilateralism resurrected. The Brussels Sugar Convention of 1902, however, was never forgotten:

> the compromise treaty package that was agreed established for the first time a multilateral trading regime, albeit for one commodity, that contained many elements that would become standard in the General Agreement on Tariffs and Trade (GATT) and other later twentieth-century liberal trade regimes. [6]

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[5] Lowenfeld (2002: 200, note 1) reports another proposal of Hamilton, that of introducing a countervailing duty for products imported into the US, with the revenue to be used to subsidize domestic production of the same products. It is not clear whether a prerequisite for this 'indispensable interference of the government' should have been that the imported goods had been subsidized. In any event, it is interesting that the US *Byrd Amendment* resembles this proposal remarkably (and, as seen in the next chapter, has been considered as illegal under WTO law in the *US – Byrd Amendment* dispute).

[6] Pigman (1997: 199).

Indeed it was not until the GATT was established in 1947 that a more comprehensive international regulation on subsidies (or 'bounties'), focussing on both unilateral reactions (Article VI) and international obligations (Article XVI), appeared. The developments on the issue of subsidies since (mainly the 1979 Tokyo Subsidy Code, the 1995 WTO Agreement and the current Doha Round negotiations on the one side and the EC Treaty on the other side) are analysed in this research.

As will soon appear from the analysis, subsidies are ambivalent in their effects. The may distort both international and domestic trade and competition, but, at the same time, they may pursue legitimate public objectives arriving where market forces alone cannot.

The issue of public subsidies is currently gaining prominence in the debate of political, legal and academic circles. This mainly depends on the increasing liberalization, privatization and globalization of the economy. Governments are retreating (shifting from direct provision to regulation) from what were regarded till now as public reserves. Their role, particularly the pursuit of the public interest, and the tools of public intervention in the economy, are all subject to a process of redefinition. Subsidies and their distortions come more and more into prominence.

These are just some of the reasons that explain why public subsidisation is increasingly becoming topical, at both national and international levels.

## 2. Research problem: the 'issue of the definition' of subsidy

The research problem can be formulated as follows. What is the best way to regulate public subsidies at an international level?

This has been, and still is, a hotly debated topic. The title of the chapter on subsidies of the classic textbook of Professor Jackson (1997: chapter 11) is 'The Perplexities of Subsidies in International Trade'. This authoritative scholar concludes the same chapter by suggesting that '[t]he subject probably merits other efforts of elaboration and definition also'.

The research problem can also be nicely formulated as the *issue of the definition* of subsidy. As came out clearly from the recent OECD's Roundtable, this should not be limited to what, strictly speaking, is considered as the definition of subsidy but, more generally to include also those rules that determine 'what is legitimate and what is not legitimate'. Hence, the title of this thesis which combines the *definition* and *regulation* of WTO subsidies and EC State aids.

These two notions are strictly interrelated with each other. It is often difficult to distinguish what is within the definition of public subsidy and what is within its regulation. Although it seems that the concept of definition should include the main constituent elements or requirements of the phenomenon to describe, in the instant case of public subsidies, in many cases, some elements are rather included within the regulation thereof.

Certainly, this also depends on the lack of clarity at a theoretical level, where, although some factors (for example the need for an advantage and the public origin) are stronger candidates for a position in the definition than others, it is difficult to draw the line. It is indeed difficult to distinguish between those elements that, using a philosophical language, should be considered as *essentials* for the notion of subsidy on the one side and those that should be regarded as *accidentals*. The writer may tentatively suggest (but this should be viewed more as a divertissement than a pretentious classification) that the *core* of the notion of public subsidy is represented by two essential elements, first the public origin and secondly the existence of an advantageous derogation. Conceptually, this might well represent a *minimal* notion of public subsidy. Other elements which more markedly concern the *impact* of the subsidy, such as its selectivity (ie that it benefits only certain undertakings) and its negative and positive effects, are more difficult to position.

The blurriness of the boundaries between definition and regulation, together with the fact that these significantly interplay with each other, justifies, in the writer's view, the use of the general – pragmatic - expression formulated by the Chairman on the OECD's Committee on Competition Policy, ie the 'issue of the definition'.

Despite this lack of clear lines between what is definition and what is regulation, we can certainly draw the line between the regulation of the substantive aspects of the

law and procedural regulation. It can be anticipated that there will not be any treatment of the procedural regulation unless this is considered as useful to explain the substantive regulation.

The writer's belief, which is increasingly being strengthened along the research, is that the best way to address the research problem is through a *comparative approach*. This again was the approach of the OECD's Roundtable where no less than eight different 'national' experiences were debated and confronted. [7] Although the merits of a comparative analysis are explained in more detail in the next section on the methodology of the research, it can already be said that the choice of the WTO and the EC as the two legal systems to compare has been dictated by the simple consideration that they represent the two most developed systems of control of public subsidies at an international level.

[7] The Czech Republic, Denmark, Finland, Italy, Korea, Lithuania, Poland, the EC.

# II. Methodology of the research

## 1. Legal and multidisciplinary analysis

After defining the scope and the research problem, it is now necessary to say something about the methods that are used in this exercise. This is a methodological section.

The first, immediate remark is that this research is done by a lawyer, and hence from a legal perspective and with a legal objective. The writer will therefore carry out its analysis by using the usual legal tools, ie the methods of interpretation that are appropriate in the various circumstances.

Although the research is legal, in many cases the writer takes advantage of the findings of other disciplines, such as economics, political science and regulation. This mainly depends on the recognition that reality is complex and different perspectives may provide useful insights and suggest solutions to the problems. The research thus benefits from an (admittedly limited) interdisciplinary approach.

In dealing with subsidies, this remark particularly translates in the reference to economics. Although the writer does not fully agree with the conclusion famously drawn by Brandeis J that 'lawyer who has not studied economics ... is very apt to become a public enemy', [8] it is clear that economics can constitute a useful aide for many reasons. The trend, particularly in the EC, is to increasingly refer to economics when solving State aid problems.

This increasing use of economics should however prompt a few warnings. Although economics is not a 'dismal science', it is not an 'exact science'. There is no ready made solution. It is a fact that economists disagree between themselves with the result that no clear answer is provided to a given problem. Further, by its nature, economic analysis may often result difficult to apply for its complexity and this to the detriment of certainty and predictability. Finally, economics mainly attempts to explain, on the basis of certain assumptions, how things *do* work and not how they *ought to* work. In other words, normative, value-based decisions are not for economists, but for policy-makers. What economics can often do is to

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[8] Reported by Whish (2003: 1).

provide the most efficient, one would say the best, way to reach a result which has been set.

Similarly, reference will be made to other sciences that can result useful in understanding subsidies and their discipline, such as political science and regulation. With the necessary amendments, caveats similar to those made above apply.

In a word, we are dealing with legal rules which have certainly to be drafted and applied soundly, taking into due account of their policy objectives and of the most effective way to achieve them. At the end, however, the result must be a system of *rules* which should guide the behaviour of international organizations, States and undertakings. So far as possible, they should feature the characteristics of clarity (and hence certainty and predictability) and workability, which are the typical (if not the exclusive) concerns of lawyers.

The balance of this research is therefore strongly towards legal analysis.

A final note. This conclusion is also the recognition of the personal limitations of the writer. Claims of universal knowledge can rarely be made. Exceptional individuals, capable of moving with ease and outstanding results among various fields of knowledge, are infrequent. [9]

## 2. Comparative analysis

### Subject and purpose

This section answers two questions.

a) What is a comparative analysis?

b) Why carrying out a comparative analysis?

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[9] History provides us with few paradigmatic examples, for example that of Leonardo da Vinci. On this outstanding personality, the reader may wish to look at Burckhardt (1860) where he defines Leonardo as a truly 'universal' man to then lapidary conclude the relevant chapter by saying: 'The colossal outlines of Leonardo's nature can never be more than dimly and distantly conceived.'

A particular emphasis will be placed on the second question as the first is blended with the issue of the method which is examined below.

Comparing means to analyse two or more entities, in the case of comparative law two or more legal systems, in the attempt to solve a (legal) problem. Comparative analysis is a useful *method of knowledge.* In very general terms, it can be said that you learn more if the analysis focuses on two or more entities, in our case two different legal systems, rather than on a single one. A similar point has been made when talking about a multi-disciplinary approach: to see the same thing from different perspectives help in understanding it.

More specifically, the assumption seems to rest on the recognition that, if problems are similar, it may be interesting to enquire how they are addressed and solved in different contexts. As Zweigert & Kötz (1999: 34) wittily underlined 'every comparatist [soon] learns ... that the legal system of every society faces essentially the same problems, and solves these problems by quite different means though very often with similar results.' [10]

As the methodological issues below show, however, comparing does not mean to expose the results of the analysis of the two or more entities (here: legal systems), that is to simply *juxtapose them.* [11] To compare rather means to *contrast* them in a *critical* fashion. What is required is to explain the convergences and divergences that have inevitably emerged from the analysis and to draw teachings from them. In a word, comparing enables a better understanding of the strengths and weaknesses of each entity.

If one wanted to concentrate on the aims and benefits of comparing, he should start from very basic remarks. As often happen, curiosity is the spark (and at the same time the inherent disease!) of research. This occurs too with comparative analysis which starts with the recognition, masterly expressed by Lord Bingham, that 'there is a world elsewhere'. It is the explorer's instinct that leads the researcher to wander through new paths and lands in the quest for an answer to a problem.

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[10] Zweigert & Kötz (1999: 34). The bracketed insertion is of the writer.
[11] Zweigert & Kötz (1999: 43).

Drawing from the previous remarks, we might attempt to sum up the goals of comparative analysis.

The first general goal of is the *enhancement of knowledge*, in the instant case of the regulation of public subsidies. [12] This is strictly linked to a crucial *cultural* and *pedagogical* - even *ethical* - value of the recognition that 'there is a world elsewhere'. In other words, comparative law can produce the awareness that our system is by no means perfect – a sort of 'benchmark' – but it features not only strengths but also weaknesses, and, most interestingly, that we can actually learn from a foreign system and the growing willingness to learn from what is foreign to us (Sacco (1992: Chapter 1)).

The improvement of knowledge inevitably leads to another crucial phase. The ultimate aim and benefit of comparative law is *critical* and the writer uses this term in its broadest and more neutral meaning. Drawing inspiration from the solutions adopted by the other system, the lawyer is naturally led to *verify* the correctness of the solutions of the two systems - inevitably referring to a model - and to propose new ones. [13]

This important critical phase, which prevents comparative law from merely being an exercise of 'piling up blocks of some that no one will build with', [14] inevitably leads to a *practical impact* which may have various dimensions.

As said, the comparative exercise may have prompted new interpretations of the existing law or even proposals for law reform. The SCM Agreement is a good example in this regard, since many of its provisions draw inspiration from EC or US law.

Comparative law can even contribute to the development of legal systems. The example of the EC is a good one. There the role of comparative law in the development of, for example, the general principles and the protection of fundamental rights has proved fundamental in the EC.

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[12] A similar motive seems to have inspired a recent comparative analysis between EC and WTO trade law. See Ortino (2004: 5).
[13] Zweigert & Kötz (1999: 46-47).
[14] Zweigert & Kötz (1999: 47) quoting Binder.

Moreover, the knowledge of other legal systems may lead to avoiding conflicts. If different legal systems have to apply to the same fact, a proper understanding of the two may allow, whenever possible, to avoid inconsistencies by interpreting one system in line with the other one. Returning to the area of public subsidies, a convergence in the interpretation of the discipline of EC State aid and WTO subsidy cannot but be beneficial.

Along these lines, it can be appreciated that the role to play by comparative law is increasingly 'urgent' in the current context of *globalization* which also involves relationships and interdependence of legal systems. [15]

## Method

This section focuses on the comparative method and its difficulties. [16] Methodology in comparative law is an intricate issue.

On the one hand, precision is required in the identification of the problem, of the systems and the rules to analyses and compare, on the comparator, and on a 'common language'. On the other hand, the faithful companions of the comparative lawyer are common sense, experience and intuition (as well as the awareness of his/her limitations and of the fact that the risk for misunderstanding is everywhere).

The comparative method therefore blends two different attitudes. This combination has been masterly summed up in two phrases, one by Zweigert & Kötz (1999: 37) whereby what is needed is 'imagination and discipline', and another by Eichendorff: 'Hüte disch, sei wach and munter', which can be translated with 'Watch out, be brave and keep alert'. [17]

### The steps of the comparative analysis

We now have to go back and analyse the most important steps of this method.

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[15] See Twining (2000: chapter 7).
[16] The following exposition benefits from the master work of Zweigert & Kötz (1999).
[17] The sentence is reported, and translated, by Zweigert & Kötz (1999: 36).

**First**, it is necessary to identify a *problem*. In our case, this has been indicated already and can be formulated in two different ways, one more general, one more precise. First: what is the definition of subsidy? Secondly: what is the best way to regulate public subsidies at an international level?

The **second** important step is the identification of the *legal systems* and, most importantly, the *rules* that need to be analysed and compared. As said, this research focuses on the regulation of subsidies and State aids in WTO and EC law. The choice of EC and WTO law depends on the fact, recognised by the OECD (2001), that they undoubtedly represent the two most developed, and hence important, disciplines of public subsidies at an international level.

It is now important to make a more technical comment which concerns the identification of specific rules to compare. The comparative lawyer should focus on those rules that, irrespective of their possible domestic qualification, perform the same *function* since they regulate the same phenomenon. In other words, only comparables can be compared, and 'in law the only things which are comparable are those which fulfil the same function'. [18] In the case of this research, the identification of these rules has been quite straightforward since the provisions that are expressly conceived to regulate public subsidies can be easily detected. Thus, the main focus in WTO law will be on the GATT, the SCM Agreement and the Agreement of Agriculture. In the EC, the attention will almost exclusively concentrate on the competition rules of the Treaty concerning State aids, ie Articles 87 to 89 EC. [19]

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[18] Zweigert & Kötz (1999: 34).

[19] It is important to underline that the analysis mainly concentrates on the interpretation of WTO subsidy rules as made by the Panels and the Appellate Body and of EC State aid rules by the Commission and the Community Courts.
No mention is therefore made to the interpretation made in the domestic countervailing duty practice of the various jurisdictions, and in particular of those of the US or the EC. For a comprehensive exposition of EC countervailing duty law see Adamantopoulos & Pereyra Friedrichsen (2001) and Van Bael and Bellis (2004). For a brief, but updated, exposition of US countervailing duty law see Trebilcock & Howse (2005: 275 et seq). Only occasionally, reference is made to domestic countervailing duty law insofar as it may be useful to show a particular point.
Analogously, the analysis does not refer to the reading made by national courts in the EC of the concept of State aid. Reference is sometimes made to the study of the topic recently entertained by some national competition authorities, such as the OFT.

That said, when necessary, the research takes into account of the rules that, albeit pursuing a different role and operating in a different manner, *may* also apply to subsidies/State aids or to similar forms of conduct.

The **third** step required by the comparative method is the development of a *language*. As Zweigert & Kötz (1999: 44) explained the comparative lawyer must 'build a system'. This requires a 'special syntax and vocabulary'. It is therefore necessary to identify concepts, categories, paradigms, in the comparative law jargon 'legal formants', that is the, written and unwritten, essential elements that characterize a given sets of rules. [20] Inevitably, this system and its concepts must be flexible enough to accommodate the differences in the compared systems.

As is explained in the last section of this chapter, the main *formative elements* of the *definition of subsidy* have been identified in the public intervention in the economy, the grant of an economic advantage, the identification of the beneficiaries, the analysis of the effects, and constitute the four core chapters of the thesis. The specific analysis of each of these broad concepts then has led to the emergence of other essential elements which, sometimes implicitly, guide the lawyer's reasoning. Interestingly, all these elements already constitute the outcome of a first comparative exercise between the two sets of rules.

**Fourthly**, a true comparative analysis, which is not merely limited to a preliminary detection of similarities and differences, but, more radically, attempts to provide *judgments* on the soundness of the solutions to the problems provided in the two legal systems, requires the identification of an appropriate comparator, or *tertium comparationis*, to be used as a model. The big issue is: where this model should be found? There is not a single answer. The model may be constituted of another legal system which is considered as a standard, it may derive from a meta-juridical analysis, ie from the examination of other disciplines such as economics. Intriguingly, it may well have emerged from the comparative exercise itself.

Further, in some cases, there is not *one* single solution. It may well be that, depending on various factors and circumstances, different solutions to a given problem can be envisaged. The comparator has thus to be necessarily flexible.

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[20] The concept of 'legal formant' has been defined by Sacco (1991); id (1992).

## The caveats of the comparative analysis

The analysis of the main steps of the comparative analysis would not be complete if we would not consider the inevitable warnings.

The first caveat concerns the *general context* (legal, political, historical, economic, etc). It is indeed necessary to take into due account of the, sometimes significant, *general* contextual differences since these may have an impact on the definition of the *specific* problem. This point is very important. The remainder of the analysis of this chapter will therefore focus on the differences, and similarities, of the two general contexts of the WTO and the EC and on the impact that these may have on the approach to legal interpretation.

Secondly, to compare does not necessarily mean to look for *similarities* or *differences.* Although the approach of the comparatist may depend on aim of his/her research, [21] in many cases, the discovery that there is a convergence or a divergence is simply the result of the comparative exercise. Whatever the aim underlying the comparative effort it, what is in any case crucial is to attempt to critically explain these similarities/convergences or differences/divergences.

## 3. The WTO and EC as two (different) (legal) contexts

The first warning that has been made above is that the general context, be it legal, political, economic or other, of two legal systems may have an impact on the comparison of two specific sets of rules within the two systems.

This paragraph, which is the outcome of a brief macro-comparison, outlines the main similarities and the differences between the EC and WTO law. The aim is just to sketch the main features of the two systems at issue.

The differences between the two systems are clear. They pursue different levels of integration with only a partial similarity in the objectives. Unlike the WTO, which is still an economic – better a 'trade' organization -, the catalogue of the objectives and policies of the EC is impressing, almost universal. Just to provide a brief insight,

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[21] See, eg, Eeckhout (2001: 211) who expressly recognises that 'this chapter is looking for similarities rather than differences'.

the EC does not merely pursue quite extensive economic policies (trade liberalization, competition, industrial policy, economic and monetary policy, infrastructure, transport, energy, agriculture, etc) but is increasingly involved in other important policy areas (regional cohesion, health, culture, environment, immigration, etc).

The different vocation of the two systems is also reflected in their membership. Despite a recent substantive enlargement, the EC is a regional organization constituted of a rather small and cohesive group of nations with a substantial degree of commonality of values and objectives. The WTO's universal vocation - it currently counts 149 Members - necessarily shows a different picture.

These general differences in aims, vocation and membership have an implication at the constitutional and institutional level. The institutional structure of the EC is both complex and mature. Generally the three functions (judicial, legislative and executive) are clearly defined and equally strong with a resulting balance of powers. An element of further solidity is given by the integration between the EC legal system and the national systems of the Member States guaranteed by the direct effect of EC law and the consequent idea that national courts and administrations are EC 'organs'. In the WTO, the institutional structure is complex but less effective. There is virtually no legislative power. As an inevitable counterbalance, however, the judicial branch, the Dispute Settlement System, is highly developed and authoritative.

An important issue, which will be soon analysed, is whether these differences may have an impact when the lawyer has to interpret the relevant rules. In other words, the crucial issue is whether there is any difference in the approach to legal interpretation in the two systems.

One might ask whether, in consideration of the important differences above, it is really possible to entertain any meaningful comparison between the two systems. More precisely, the problem would not only be at a *macro* level but even at the *micro* level of the rules that specifically regulate certain phenomena, say tax discrimination, quotas, general justifications, and ... subsidies.

Although not spelled out expressly, this objection was certainly in mind of Eeckhout (2001: 211) when, introducing his comparison between the law on free circulation of services in the EC and in the WTO law, and making adamant that he was not proposing that one system should have been the model for the other, he felt it necessary to acknowledge that:

> There are obvious differences, in wording, objective, context, and scheme of liberalization mechanisms in the respective systems. But that does not mean that comparison could not be enriching…

The writer might add that the justification for carrying out a comparative exercise between rules that regulate the same phenomenon and, from this perspective, pursue the same function is not precluded by the differences, even in objectives, in the general legal systems.. Far from being an obstacle to the comparison between rules that regulate the same fact, this difference in objectives (at both *macro* and *micro* levels) is certainly a factor, among the others, that has to be taken into account in the comparison.

At a more general level, it should also be added that, when comparing the regulation of economic activities, usually the differences tend to wither. This is certainly due to the ongoing processes of liberalization which produce an impact, even cultural, towards uniformity which goes well beyond the limited arena of commercial struggle.

In other words, the aim to reach a certain – albeit minimal – degree of liberalization of the economy seems to represent a *leit motif* in the regulation of economic activities and of the obstacles thereof. [22] This common denominator makes the comparison between the rules that in various legal systems govern these phenomena appropriate.

We might even go further. Not only is it common to find similarities in the rules concerning economic phenomena, but, more generally, there is an increasing

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[22] Bognetti (1994).

tendency to give more *legal* relevance also to non-economic considerations and the protection of fundamental rights). [23]

## Legal interpretation

One of the most important issues for the current analysis is the impact of the general context on the approach to legal interpretation.

There is no mistaking that law and interpretation is one and the same thing.

Legal interpretation is a fascinating topic, particularly in an international law context. One scholar once uttered that there is no part in the law of the treaties which he approaches with more trepidation than the question of interpretation. [24] Certainly, most of the passion that it arouses depends on its elusiveness, on the fact that the process of interpretation is by its own nature more an art than a science. [25] Although the interpreter has at its disposal various, and to some extent long-established, rules of interpretation, their actual scope is not settled, being rather flexible, and, most importantly, the relative weight of these rules in the process of interpretation may substantially differ. This can greatly affect the approach to interpretation and its outcome.

In the next two sections the approach to legal interpretation in the WTO and in the EC is briefly examined.

## The approach to legal interpretation in the WTO

One of the first fundamental steps made by the newly constituted Appellate Body, a true sign of the WTO's more legally oriented dispute resolution system, was to define the rules of interpretation it would follow. It did so in interpreting Article 3.2 DSU that in its second sentence states that the dispute settlement system serves to clarify the existing provisions of the covered agreements 'in accordance with customary rules of interpretation of public international law'. In two important reports the Appellate Body found that Articles 31 and 32 of the Vienna Convention

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[23] For a review see Trebilcock and Howse (2005: chapters 13, 17, 18 and 20).
[24] Sinclair (1984) page 114, referring to (and agreeing with) McNair.

on the Law of Treaties ('VCLT') have attained the status of rules of customary international law relating to treaty interpretation. [26]

The 'general rule on interpretation' can be found in Article 31(1) VCLT which reads that 'a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose'. Article 32 on the 'supplementary means of interpretation' provides that 'recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of Article 31, or to determine the meaning when the interpretation according to Article 31: (a) leaves the meaning ambiguous or obscure; or (b) leads to a result which is manifestly absurd or unreasonable'.

Professor Ehlermann (2002: 615-616), a former judge of the Appellate Body, has summed up the approach of the Appellate Body with respect to these criteria. The Appellate Body attaches the greatest importance to the first criterion, ie 'ordinary meaning of the terms of the treaty'. The 'context' is given less weight than the first, but it is certainly been more relied upon than the third, the 'object and purpose'. Little importance is by contrast attributed to the 'preparatory work of the treaty'.

This seems to closely follow the balance struck by the VCLT. Article 31 VCLT includes a 'general rule of interpretation'. The use of the singular ('rule') instead of the plural ('rules') is a clear indication that the process of interpretation envisaged by that provision is 'a single combined operation', in other words a 'holistic' approach. [27] The holistic, or global, nature of the rule means that its application should not involve a strict sequential examination where the assessment of each criterion is completely separate from the others.

That said, it is clear that, if *all* the criteria indicated in Article 31 should be used in order to reach the appropriate interpretation, it seems that, in this process, *some* have more weight than others. This is clearly explained by Sinclair (1984: 117), who actively participated in the Vienna Conference as a delegate:

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[25] Sinclair (1984) page 118. Cf also Brown & Jacobs (2000) page 323.
[26] *US - Gasoline*, para 3; *Japan - Taxes*, para 97. A similar view was expressed by Sinclair (1984: 153).

> [t]he Convention rules on interpretation reflect an attempt to assess the *relative value* and *weight* of the elements to be taken into account in the process of interpretation rather than to *describe the process of interpretation itself.* [28]

Indeed, apart from implying that the process of interpretation should be a single, combined operation, its actual operation is not described and it is for the interpreter to face it in each individual case. What Article 31 VCLT does it to give a 'relative value and weight' to the various elements of the general rule.

In particular, this 'general rule' *certainly favours* a 'textual approach', with *some relevance* given to a strictly interpreted 'purposive method' and *little weight* to the 'subjective method'.

Among the various criteria enshrined in the holistic general rule of Article 31 VCLT, the examination of 'the ordinary meaning of the terms of the treaty' (so-called literal or textual interpretation) is certainly the most important one. On the clear premiss that it should represent the most direct expression of the intentions of the parties, the text of the treaty constitutes the natural starting point of any process of interpretation. Sinclair (1984: 121) underlined that the 'ordinary meaning' does not necessarily result from a pure grammatical or linguistic analysis but has to take account of all the consequences normally and reasonably following from the text. In other words, the interpretation of legal rules necessarily has to take their *practical* application into due account.

Most crucially, as Pauwelyn (2003: 245) notes, the text of the treaty is the necessary *reference for* and the *limitation of* the other tools of treaty interpretation. Since interpretation is about giving meaning to existing rules and not about creating new rules, it cannot go either *beyond* or *against* the text of the rule in question.

According to Ehlermann (2002: 616-617), these considerations show how, in the WTO, the heavy reliance on the 'ordinary meanings of the terms of the treaty' by the Appellate Body and the Panels has contributed to 'providing security and

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[27] See the ILC Commentary (1966: vol II, 219-220). Brownlie (2003: 633); Shaw (1997: 656); Lennard (2002: 22-23).
[28] Emphasis added.

predictability of the multilateral trading system' (Article 3.2 DSU, first sentence) and has had a legitimizing effect of the activity of the dispute settlement organs, by keeping at bay the criticisms that they were attempting to 'add or diminish the rights and obligations provided in the covered agreements' (Article 3.2 DSU, third sentence).

Although it may be obvious, [29] Article 31(1) VCLT hastens to add that the terms of the treaty should not be read in the abstract but should be put 'in their context' which is constituted by the text of the treaty, including its preamble and annexes, and any other agreements related to the treaty or drawn in connection with it. The most important issue here is the identification of the most appropriate context in the case at hand. Although the WTO is one single agreement, the various instruments and provisions can certainly be distinguished between themselves on the basis of various considerations (such as *lex specialis*), and hence, through interpretation, we may certainly identify a more or less immediate and appropriate context.

Particularly significant is the remainder of Article 31(1). The interpretation of the 'ordinary terms of the treaty in their context' shall be read 'in the light of' the 'object and purpose' of the treaty. Lennard (2002: 27) has intriguingly claimed that also the object and purpose of the *provision* under examination may become relevant insofar as it is evidence of the object and purpose of the treaty.

Most importantly, the phrase *in the light of* arguably indicates that purposive or teleological interpretation is seen as a secondary and ancillary tool. In any event, as confirmation of the centrality of the text of the treaty, it is generally said that the object and purpose of a treaty are primarily to be gathered therefrom (and particularly, if there is any, from its preamble). [30] Whereas this anchorage to the text of the treaty may well circumscribe the more radical risk that the interpreter imports what can be viewed as its own object and purpose of the treaty, the fact remains that, for various reasons, it may be particularly difficult to identify them. Sinclair (1984: 130-131) rightly observed that most treaties, and this is particularly true with

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[29] Jacobs (1969: 334); Lennard (2002: 24).

respect to multilateral conventions, have more purposes, and quite often these may be in conflict with each other (as the fact itself that a dispute arises may show).

We may conclude our analysis of the main criteria expressly set forth in the VCLT with the supplementary means of interpretation referred to by Article 32, and in particular the preparatory works. As said, the recourse to the latter is not very common. This is partly due to the fact that these are accorded a secondary role in the process of interpretation. However, the caution in referring to them seems more radically to depend on two other arguments clearly summarized by Sinclair (1984: 142). The relevant passage deserves a full quotation:

> the obscurity of a particular text will often find its origin in the *travaux préparatoires* themselves. The natural desire of negotiators to bring negotiations to a successful conclusion will often result in the adoption of vague or ambiguous formulations. Sometimes the parties will have deliberately wished to avoid too much precision in order to allow themselves in future to argue that the provision as formulated does not commit them to an inconvenient or too onerous obligation. Finally, the *travaux préparatoires* are unlikely to reveal accurately and in detail what happened during the negotiations, since, more often than not, they will not disclose what may have been agreed between the heads of delegations during private corridor discussions.

Whereas the first argument highlights the substantial *inconclusiveness* of the recourse to the preparatory works, the second argument warns against the *unreliability* of the records of negotiations. Crucially, both these inconveniences suggest that the insight into negotiations, far from providing the sought clarification, might in fact divert from the results that, despite any uncertainty, have emerged from the primarily textual interpretation under Article 31 VCLT. [31]

It is finally important to briefly refer to two other rules of treaty interpretation, not expressly codified in the VCLT, which have been used by the Appellate Body and may be relevant for our analysis.

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[30] Sinclair (1984: 118); Jacobs (1969: 337). Lennard (2002: 29) notes that the ILC Commentary (1966: vol II, 221) considered the reference to the 'object and purpose' of the treaty as referring to *expressed* objects and purposes, particularly, but not exclusively, as expressed in the preamble.
[31] For a similar argument cf Brownlie (2003: 636).

The first is the principle of effectiveness (also known as *ut res magis valeat quam pereat* or *effet utile*). This requires that

> when the treaty is open to two interpretations one of which does and the other does not enable the treaty to have appropriate effects, goods faith and the objects and purpose of the treaty demand that the former interpretation should be adopted'. [32]

The Appellate Body has accordingly noted that 'interpretation must give meaning and effect to all the terms of the treaty. An interpreter is not free to adopt a reading that would result in reducing whole clauses or paragraphs of a treaty to redundancy or inutility'. [33]

The common interpretation is that this finding is an expression of the principle of effectiveness. [34] This interpretation is 'based upon the presumed interest of the authors to make the treaty provisions effective rather than ineffective'. [35] With a nice expression, Pauwelyn (2003: 249) has summarized this finding as requiring that 'words cannot be *interpreted 'out of'* WTO provisions'. An interesting point is put forward by Trebilcock and Howse (2005: 133-134). The Appellate Body would have reinforced the textual approach to the treaty by responding to the previous alleged 'tendency of panels to overlook exact textual wording in order to give effect to what they see as the "object and purpose" of the treaty as a whole'.

We can now pause for a moment and ask whether this principle of effectiveness really differ from the interpretation 'in the light of the object and purpose of the treaty', or whether they rather are two different ways - possibly with a different emphasis (one referring to the text, the other to the object and purpose) - to describe the same thing. [36]

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[32] ILC Commentary (1966: vol II, 219).
[33] *US - Gasoline*, paragraph 23; confirmed in, *inter alia*, *Japan - Taxes*, paragraph 12.
[34] Pauwelyn (2003: 249).
[35] Sinclair (1984: 118).
[36] On the point see Sinclair (1984) page 118. In particular, it has been argued that the approach based on effectiveness is a matter of necessity based upon the presumed interest of the authors to make a treaty provision effective rather than ineffective. By contrast, the teleological approach would require a much more subjective appreciation by the would-be interpreter of what were the aims of the parties.

In any event, both principles raise the same concern. They can be close allies of the text, giving it its full meaning, but, if pushed too far, they may turn against it. This has been raised by Pauwelyn (2003: 249) when he noted that there may well be a tension between effective and textual interpretation.

The Appellate Body itself seems to have understood the risks of a too much liberal interpretation (that is too remote from the text **and** the object and purpose of the treaty) when it noted that the Vienna Convention 'principles of interpretation neither require nor condone the imputation into a treaty of words that are not there or the importation into a treaty of concepts that were not intended'. [37]

This finding shows two things. First, that, in the same way as it is not possible to read words 'out of' the treaty, words cannot be read 'in' the treaty (cf Pauwelyn (2003: 249)). Secondly, it shows the connection between what sometimes is called extensive interpretation and what sometimes is called purposive interpretation. The first part of the finding refers to imputing into the treaty 'words that are not there', with a clear emphasis on the text, the second part, which mentions the importation into the treaty of 'concepts that were not intended', seems to use a different language. A language which may well hint at a broader analysis of the object and purpose of the treaty.

The result of this analysis is that, with respect to both effective and purposive interpretation, the problem is to go against the text which should represent both the basis and the limit of the general rule of interpretation of Article 31.

In the *Hormones* dispute, the Appellate Body has also referred to the principle of restrictive interpretation, also known as *in dubio mitius*, whereby 'if the meaning of the term is ambiguous, that meaning is to be preferred which is less onerous to the party assuming an obligation, ... or involves less general restrictions upon the parties'. [38]

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[37] Appellate Body, *India - Patent*, paragraph 46.
[38] See Appellate Body, *Hormones*, paragraph 165.

Leaving aside the issue of whether the principle was actually relevant in the *Hormones* dispute, [39] it seems that this rule is increasingly less used and subject to criticism. [40] As early as in 1961, Lord McNair expressed the view that it was of declining importance and dated 'from an age in which treaties were interpreted not by legal tribunals, and not even much by lawyers but by statesmen and diplomats'.

Underlying the *in dubio mitius* principle is the idea of deference towards the sovereignty of the states. The writer does not touch the current intriguing debate on the concept of sovereignty, wittily dubbed as one of the 'mantras' of WTO. [41]

The fact is that, in a treaty, very much like in any contract between private parties, one party's obligation usually corresponds to another party's right. As Pauwelyn (2003: 186, note 57) noted, 'to interpret obligations for one state restrictively could, indeed, amount to not giving the intended effect to the rights of another state'. A treaty is the result of a sophisticated exercise of balance of obligations and rights as has been recognised by the Appellate Body itself in the *Japan - Taxes* case. The particularly illuminating passage deserves full quotation:

> [t]he *WTO Agreement* is a treaty - the international equivalent of a contract. It is self-evident that in an exercise of their sovereignty, and in pursuit of their own respective national interests, the Members of the WTO have made a *bargain*. In exchange for the benefits they expect to derive as Members of the WTO, they have agreed to exercise their sovereignty according to the commitments they have made in the *WTO Agreement*. [42]

The writer's final proposition, which is also of more general relevance, is that the admittedly balanced approach of the mainly textual analysis of the Vienna Convention is capable enough to capture, in each given case, the bargain underlying the words of the WTO Agreement.

The issue of interpretation is currently very topical in the context of WTO law. The recent *US – Gambling* dispute seems to have put the proper tuning of the customary

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[39] Even on a plain textual interpretation, it was clear that the Panel's equation between the terms 'based on' and 'conform to' in respectively Articles 3.1 and 3.2 of the SPS Agreement was not correct. As the Appellate Body found, one ('conform') *clearly* required of Members 'much more' than the other ('based on').
[40] Brownlie (2003: 636); Pauwleyn (2002: 186).
[41] See Jackson (2006).

rules of interpretation of public international law, and in particular of the rules of the Vienna Convention of the Law of Treaties, at the top of the agenda of international trade lawyers. The need to fully give meaning to the 'holistic' 'general rule' of Article 31(1) VCLT seems to be the motto. [43]

We would like to conclude by quoting an interesting passage of Pauwelyn (2003: 245-246) which shows the potential (and at the same time the limitation) of this rule. The example cited is the interpretation of 'exhaustible natural resources' under Article XX(g) GATT made by the Appellate Body in *US – Shrimps*.

> First, interpretation ... is about giving meaning to the terms of a treaty. It is a matter of definition. Second, interpretation must be limited to giving meaning to rules of law. It cannot extend to creating new rules. *Within the process of treaty interpretation*, other rules cannot add meaning to WTO rules that goes either *beyond* or *against* the 'clear meaning of the terms' of the WTO rule in question. Interpretations *contra legem* are prohibited. Interpretation thus allows, for example, reading the WTO term 'exhaustible natural resources' to include *certain living species* with reference to international environmental law (such inclusion does not run counter to the 'clear meaning of the terms'). Interpretation, would, however, prohibit this term being read so as to include also resources which are 'clearly' *not* exhaustible (such as tomatoes) or resources that are 'clearly' *not* natural (such as plastic).

## The approach to legal interpretation in the EC

No express reference by the ECJ to any method of interpretation in particular can be found.

A corollary is that the ECJ does not follow the methods of interpretation prevailing in public international law when interpreting EC law (the case is of course different when it is necessary to interpret international agreements binding on the Community). [44]

When it comes to defining the general approach of the Court to legal interpretation, it seems that the words uttered by a former President of the Court in 1976 are still relevant:

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[42] Appellate Body, *Japan - Taxes*, paragraph 15, emphasis in the original.
[43] See, eg, Ortino (2006).
[44] Eeckhout (2004: 256 et seq).

> The literal and historical methods of interpretation recede into the background. Schematic and teleological interpretation ... is of primary importance. [45]

Further, according to Kutscher, contextual and purposive interpretation 'are closely interlocked in the case-law of the Court'. [46]

The main implication that can be drawn is that the text does not generally represent a limit.

In this regard, Brown and Jacobs (2000: 326) noted:

> [f]aced as it often is with texts which are vague, ambiguous or incomplete, the Court has recognised the limitations for itself of the literal methods of interpretation. Particularly, after 1958, when the Court was confronted with the more programmatic EC Treaty, its interpretation shifted perceptibly towards the contextual and teleological, with emphasis on the *ratio legis* and the objectives of the Treaty.

In another passage, the favour for the teleological approach is again explained as being 'peculiarly appropriate in Community law where ... the Treaties provide mainly a broad programme or design rather than a detailed blue-print'. [47]

This has been considered appropriate on the premiss that the Treaties are (already) substantially a *Constitution* and the Court of Justice a *Constitutional Court.* [48]

The Court's reasoning therefore puts a heavy reliance on context and, in particular, on teleology and *effet utile* with the result that EC law is usually interpreted quite freely and liberally. Indeed in EC law purposive interpretation has various applications. Referring to the crucial objective of integration underlying the common/single market the expression 'integrationist' interpretation has also been used. [49]

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[45] Kutscher (1976: 16).
[46] Kutscher (1976: 40).
[47] Brown and Jacobs (2000: 339).
[48] Jacobs (1992: 32); Tridimas (1997: 199); Albors-Llorens (1999: 373)
[49] Pescatore (1974).

One of the most notable example is the famous *Van Gend en Loos* case [50] where the Court laid down the principle that the Community constitutes a 'new legal order' and that Community Law can have direct effect, that is can give rise to rights that individuals can invoke before national courts and that the latter have to protect. If the reasoning of the Court is looked at for a moment, what is meant by contextual, purposive and integrationist approach can be fully appreciated. [51]

This approach has sometimes been negatively dubbed 'judicial activism' and subject to strong criticism. [52]

In any event, it cannot however be said that the Court does never feel to be constrained by the Treaty language. In the recent *UPA* case, [53] contrary to a powerful Opinion of Advocate General Jacobs, the Court found not to be able to construe the notion of 'individual concern' in Article 230(4) EC more liberally since this would have meant running against the text of the Treaty.

## Brief comparative comments

Ehlermann (2002: 616) has recently summed up the difference in approach to interpretation in the two legal systems:

> [w]hile the Appellate Body clearly privileges "literal" interpretation, the ECJ is a protagonist of "teleological" interpretation.

The big difference between the two systems seems thus to depend on the different *weight* given to respectively *textual* and *purposive* interpretation.

In turn, this difference in approach to legal interpretation partly justifies different judicial styles. If one has to be - or, at least, show to be - particularly faithful to the wording of a treaty this will require a particularly elaborate style where every step of the reasoning is put down, sometimes various times but with different formulations.

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[50] Case 26/62.
[51] Ibid pages 12 and 13. On this case see Pescatore (1983).
[52] Rasmussen (1986).
[53] Case 55/00P *UPA*.

Conversely, the style of the Court of Justice is definitely more concise, sometimes even cryptic.

From a lawyer's perspective, probably the two styles are excessively extreme, in either direction. Dispute settlement organs, particularly Panels, would better attempt to simplify. On the other hand, the Court of Justice may sometimes be less hermetic in its reasoning.

But these remarks forget the political dimension. Like the different emphasis in the use of the methods of legal interpretation, it may well be argued that the two different judicial styles – extremely elaborate vs extremely concise - are ultimately a reflection of the different need for legitimacy required by the two tribunals. Hermetism or unclearness are often a different story and may be explained with lack of consensus.

## III. Exposition of chapters, selection of issues

We have seen that one of the main steps of the comparative analysis is to identify the essential categories, or the legal formants, of the 'issue of the definition of subsidy' in the two legal systems.

Four *macro* elements of the 'issue of the definition of subsidy' have been identified:

a) the public intervention

b) the derogation/advantage

c) the beneficiaries

d) the effects

These four general categories will be analysed in turn in the following four chapters which constitute the core of the thesis.

The underlying drift may easily be noted. We start from concentrating on the actor and its conduct to progressively move towards the mechanism and the impact of its action that are liable to produce negative and/or positive effects.

It is finally important to underline that, in his effort, the writer has necessarily had to make a *selection* in the 'vast universe of subsidies' [54] and focus only on those problems that, in his view, are particularly significant to explain the underlying trends of the 'issue of the definition of subsidy'.

In his *Parallel Lives*, in the beginning of the book on Alexander, Plutarch noted:

> [j]ust as painters get the likenesses in their portraits from the face and the expression of the eyes, wherein the character shows itself, but make very little account of the other parts of the body, so I must be permitted to devote myself rather to the signs of the soul in men, and by means of these to portray the life of each, leaving to others the description of their great contests.

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[54] Appellate Body, *Canada – Aircraft*, paragraph 47.

The writer has similarly attempted to analyse those 'signs of the soul' of the subsidy and State aid rules which better 'portray the life of each'. In doing so, it may well be that, in many cases, he has omitted 'the description of their great contests', leaving it to others - or indeed to his future research.

# Chapter 2

# The Public Intervention

## I. Scope of the chapter

The initial step of the analysis is to concentrate on the first requirement of the definition of subsidy or State aid which is the *public intervention.*

This chapter attempts to answer three questions on the governmental action that are progressively more critical, in the sense of both analytical and crucial. In particular:

- what action *might in principle* amount to a subsidy or a State aid,
- what action *does in fact* constitute a subsidy or a State aid under the two legal systems, and, finally and most significantly,
- what action *should* be considered a subsidy or a State aid under the two regimes.

We begin our examination with an introductory section which answers the first question and, at the same time, provides the necessary foundations for approaching the two other issues. This introduction is followed by the central part which mainly analyses the current state of the law in the two systems (and at times evaluates it). The more critical and comparative remarks are left to the conclusive section.

# II. Introduction: the Public Intervention in the Economy

In this introductory section the analysis focuses on the forms of public intervention in the economy that may in general confer an economic advantage, and may thus *in theory* be covered by subsidy or State aid rules. Having in mind the findings of this analysis, we will afterwards examine the techniques that may actually be used to determine the legal relevance of the action of the government in a system regulating subsidies.

## 1. Forms of public intervention in the economy and grant of economic advantages

Governments may – and do - intervene in the economy for various reasons and in various ways. [55]

Quite crucially, this intervention may *produce an impact*, be it positive or negative, *on undertakings*. [56] When a positive impact occurs we may be entering in the territory of public subsidies. This land is however full of uncertainties. It has been noted that

> ... in considering which government actions may be regarded as providing subsidies, the term subsidy can be all-embracing. Virtually *every* government action can be regarded as a subsidy for someone, and virtually all such actions can affect international trade. [57]

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[55] This is indeed the subject of study of ***normative*** or ***welfare*** economics, the 'branch of economics dealing with normative issues. Its purpose is not to describe how the economy works but to asses how well it works': Begg, Fisher and Dornbusch (1997: 240). With a different language, this is the part of economics which concerns how the economy ***ought to*** be run: Black's Dictionary of Economics (2002: 326, emphasis added). On the intervention of the State in the economy see Barr (2004: *passim* and 72 et seq); Stiglitz (2000: *passim* and 27 et seq).

[56] For the sake of accuracy, we may immediately underline that to intervene in the economy does not necessarily mean that the government operates ***in the market*** as its conduct may affect undertakings also when it acts ***qua*** government, for example by levying taxes or introducing rules. The next chapter will show that the distinction market/non-market conduct has an important impact on the analysis of of the advantage, and in particular of the benchmarks that are used therein.

[57] Snape (1991: 140). Along the same line, but in a more economic jargon, Low (2001: 103) observed that: 'any intervention that affects relative prices or the conditions of competition in a market can, at least in theory, be expressed as a subsidy or tax equivalent'. With another definition, which importantly underlines the impact on producers' costs, it is said that a subsidy is 'a payment by the government to consumers or producers which makes the factor cost received by producers greater than the market price charged by producers': Black's Dictionary of Economics (2002: 451).

What we are attempting to do here is to focus on the *forms* of governmental action that may be regarded, at least in theory, as subsidies or State aids. Drawing inspiration from a distinction recently set forth in OECD (2001: 25-28), and concerning financial transfers, public goods, regulatory and tax policies, it is possible to identify in general three different forms of government action that may confer an *economic advantage* on undertakings and that, by distorting competition and trade, may hence be regarded as subsidies or State aids. These forms, ie financial assistance, public goods and regulation, are analysed in turn.

## Financial assistance and publicly provided goods or services

The government may firstly provide *financial assistance* to some undertakings by transferring economic resources to them in various ways. This for example occurs with grants, capital injections, loans, guarantees, provision or purchase of goods or services, special or differential tax treatment.

Secondly, any government may provide goods or services (such as infrastructures, education, public order) that, despite being in principle open to all members of society (hence generally called *public goods*), [58] in certain circumstances may have a favourable impact only on certain undertakings.

## Regulation (and deregulation)

It is finally possible to confer an advantage on certain undertakings by *regulating* or *deregulating* their business environment, that is by introducing or removing rules on and restrictions of economic activities. OFT (2004: note 10 at 4) generally noted that 'regulations that alter the costs incurred by businesses could also be considered to be subsidies'.

The government may control the functioning of markets, for example the quantity and price of the relevant goods or services, by way of *regulation*, that is by *introducing* rules and restrictions in these markets. Governments may affect prices and quantities in quite an immediate way by fixing (minimum or maximum) prices

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[58] For an analysis and application of the proper economic meaning of public goods see chapter 3.

and/or imposing obligations to sell or buy the relevant products. Governments may also adopt a less direct course of conduct, for example by introducing border measures, such as import or export barriers which, by respectively reducing or increasing the quantity of goods or services in the market, may result in an advantage for those undertakings that sell or buy them in terms of, respectively, higher or lower prices.

In other cases, with a course of action usually called *deregulation*, the government may decide to *relax*, or *remove* altogether, rules and restrictions, for example labour or environmental standards, that are applicable to undertakings and thus benefit them.

It may immediately be highlighted the inherent 'double-way effect' of regulatory intervention. To impose or lift restrictions on some individuals almost inevitably means that, more or less directly, restrictions are conversely lifted or imposed on other subjects. Along the same line, there is a similar redistributive impact. Resources are reallocated so that the enrichment of some inescapably corresponds to the impoverishment of others (which, to be true, may also occur in some cases of indirect financial assistance).

This consideration leads us straight to the core of the next paragraph, and to the two crucial concepts of *indirect action* and of *transfer of economic resources.*

## 2. The distinction between financial assistance and regulation

### The importance of distinguishing

We may now compare financial assistance and regulation. [59] Far from being of mere academic interest, this comparison is helpful to introduce *issues* and *concepts* that will become familiar in the further analysis. It is also useful to introduce the basic elements for the examination of the controversial issue of the treatment of regulatory measures in the two systems.

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[59] Most of the observations we are making with respect to the cases of financial assistance can substantially be transposed to the provision of public goods.

## The complexities of indirect action

It may be suggested that, in general, financial assistance and regulation differ with respect to the degree of *complexity* of the action of the government and of the relevant transfer of economic resources. In other words, the mechanism whereby the economic advantage is conferred seems *usually* to be more complex in regulation than in financial cases.

The first element of complexity of regulatory conduct depends on its indirect course. When the government provides financial assistance it usually (albeit not necessarily) does so directly. This is not the case for regulatory measures which, in a more or less immediate way, seems *always* to involve an intermediary in the transfer of economic resources, with the consequence that the public intervention may appropriately be defined as *indirect.*

The main aspect of complexity of indirect action is whether the conduct of a third party - which, in principle, may act autonomously - may be *associated with*, or, in a more legal jargon, may be attributed or imputed to the government.

The direction exercised by the government does not always feature the same degrees of *clarity*, *immediacy* and *intensity*, ranging from straight ordering somebody to do something to merely creating the conditions to enable the latter to perform that conduct. It can however quite safely be suggested that, if compared with measures of indirect financial assistance, regulatory measures are commonly connoted by *less* clear, immediate and intense degrees of direction. A good example thereof is when the government attempts to influence the quantity and the price of a product in the domestic market by introducing *border measures* such as export or import restrictions.

Another difficulty of the indirect action is that it is not always clear to determine *whom* the government is actually *directing.*

This is particularly so in the cases of regulation and substantially depends on the 'double-way effect' that we have underlined above whereby one party's burden necessarily corresponds to another's advantage. We may, for example, think of the case of *price regulation.* In the case of the fixing of a minimum price, shall we say that it is the buyer that is *ordered* to pay it or, from another perspective, the supplier is *ordered* to charge it? The converse is obviously true for maximum prices. Is it the

producer that is *prohibited* to charge more, or is it rather the buyer who is *entitled* to pay that price?

Despite some hesitation the most natural conclusion seems to be that the party that is most immediately subject to the direction of the government is the one that, in all probability, has an opposite interest to the measure, ie the buyer who is *ordered* to pay the minimum price, or the supplier who is *prohibited* to charge more than the maximum price. From another perspective, it seems that the directed party is the *intermediary* through which the financial support is effected.

A different conclusion can be drawn in some cases of *deregulation* where the governmental measure seems to be immediately directed to the *beneficiary* undertaking, for example by *exempting* it from certain rules or restrictions (such as labour or environmental standards), and not to the intermediary. This measure almost inevitably affects a third party (following the examples above, the employees or the undertakings supplying environmental devices or services). It seems however that this third party, which may still be considered as the intermediary of the governmental conduct since the financial support necessarily passes through it, is subject to a lesser degree of direction as compared with, say, an *order* or a *prohibition* immediately directed to it.

## The complexities of the financial dimension

The complexity of the mechanism of conferral of the economic advantage may have an impact on the *clarity of its financial dimension.*

Although any public intervention is liable to produce an economic impact on undertakings, and more specifically an allocation of economic resources (whereby the benefit to one party is somewhat linked to the burden to another), it is not always possible to identify a *clear transfer* of economic resources from one party to another.

In the cases of financial assistance the existence of a transfer of economic resources is normally particularly clear. This may partly be explained by the fact that we are often dealing with direct governmental action or that, in the case of indirect action,

the measure does not involve a great degree of complexity. Last, but not least, we are usually dealing with commonly accepted forms of subsidy.

By contrast, such transfer of economic resources is more difficult to identify for some forms of regulatory action. We may think of the cases of deregulation discussed above where the direct addressee of the action of the government seems to be the beneficiary of the measure and the intermediary is only affected derivatively. What seems to emerge from these cases is that the *clarity* of the transfer is proportionately linked to the role played by intermediary. In other words, the *less active* the latter is the *less clear* the former seems to be.

An ancillary point concerning the financial dimension of the action focuses on the origin of the resources that are used to finance the transfer. Generally, whereas the large majority of cases of financial assistance inevitably involve a transfer of *public* resources, regulatory measures usually call for a use of *private* resources. This may well depend on the fact that in the former the government usually acts directly whereas in the latter it almost invariably relies on the role of third parties. More radically, this seems to depend on the fact that the most commonly accepted forms of subsidy, which certainly belong to the category of financial assistance, are strictly linked to the government's *prerogative to tax and spend the collected revenue* (which is quite separate from the *prerogative to regulate*).

## The role of rules

We have seen that most of the complexities of regulatory measures are connected to the fact that, in those cases, the government acts indirectly. Nevertheless, since governments may also provide financial assistance through an intermediary, this cannot be the truly distinguishing element between what financial assistance is and what regulation is. Analogously, the clarity of the financial element in itself does not provide conclusive indications.

Although it is sometimes difficult to draw the line and distinguish with precision between financial assistance and regulation, it is suggested that a useful perspective – which does not have the pretension of being more that a good but modest rule of

thumb - is represented by the *role played by the rules* in the process of conferral of the advantage.

As a direct consequence of the *rule of law*, governmental conduct necessarily finds its legal basis in rules. The previous analysis seems however to suggest that financial assistance measures feature both a particularly clear and rather immediate transfer of economic resources. Whereas the regulatory element stays in the background, they seem to be characterised by a clear *financial component.* By contrast, the financial dimension of regulatory measures is not always represented by clear and immediate transfers of economic resources. It is the introduction or removal of rules (and restrictions) that plays a crucial role in the mechanism of conferral of the economic advantage with the consequence that they are particularly denoted by a *regulatory component.*

### A reminder on the importance of the previous analysis: introducing useful issues and concepts

After this long – and exhausting – theoretical analysis, it may be useful to recall its purpose to the reader.

In itself, the question of whether the measure at issue is one of financial assistance or of regulation is of limited importance. This is not the case for the various *issues* and *concepts* that have emerged from the previous analysis. These are crucial tools in order to answer the most important questions of what action does, or indeed should, constitute a State aid or a subsidy under EC and WTO law.

## 3. Techniques to define the legal relevance of the public intervention

Before turning to the analysis of the actual coverage of WTO and EC law, it is necessary to examine the techniques that may be used to define the legal relevance of the public intervention, that is to determine what forms of governmental action are covered by the provision at issue.

These techniques, which interestingly reflect most of the issues and concepts that have been analysed in the previous paragraph, will be taken into account when examining the two legal systems.

## Formulation of the definition

The first, general method is the *formulation of the definition.*

Definitions may be formulated in different ways. They may be sufficiently specific so as to cover only certain forms of action, for example those that involve clear and direct transfers of economic resources, or they may be more generally worded with a potentially wider coverage, comprising more indirect and complex measures granting economic advantages.

Further, they may, more or less explicitly, distinguish measures according to their (financial or regulatory) nature.

## Rules of imputability

The second technique refers to those cases of indirect action when, in one way or another, the government acts through a third party. The main legal issue is whether the government may be held responsible for the conduct of the third party.

We have seen that the direction of the government may be connoted by various aspects of complexity. Definitions reflect this complexity in the relevant *rules of imputability.* Crucially, these may be crafted in different ways, which are more or less sophisticated and comprehensive. A final, legal gloss. Even if, generally speaking, the involvement of the government in the conferral of the economic advantage is particularly clear, for example in the cases of deregulation discussed above, the determination of its *actual responsibility under the provision at issue* may still be an issue since it fully depends on the formulation of the relevant rule of imputability.

### Origin of the resources

The third method to determine the relevance of the measure at issue focuses on the *origin of the resources* used to finance the action of subsidisation. A long-standing issue in the two systems is indeed whether the definitions of subsidy and State aid should necessarily require a cost to government or may also be financed with private resources.

### Objective of the measure

Finally, the fourth technique concerns the *objectives* of the public intervention. The government usually acts in the pursuit of various public policy objectives.

What is interesting to ask - a truly recurring theme in all the steps of our analysis - is what role is played by the objectives of the measure in its assessment under subsidy and State aid rules, and, in this chapter in particular, in the context of the definition of the action by the government. Because of its general relevance, we will examine the role of the objectives in a final section which deals with EC and WTO law together.

## 4. The legal treatment of regulatory measures

An economic advantage can be granted through various forms of public intervention. As the reader may certainly have guessed by now, one of the most intriguing legal problems, to which particular attention is devoted in this chapter, is the treatment of regulatory measures under subsidy and State aid rules.

What can already be anticipated is that this issue cannot be given an *easy*, or better, an *unequivocal* answer. Regulatory measures may take various forms and legal provisions may be drafted in different ways. A conclusive answer cannot be provided before having analysed each of the provisions of the two systems and assessed whether the requirements provided for therein are satisfied by the form of regulation at issue.

## Omission and derogation: a crucial distinction revolving around sovereignty

Nevertheless, we can immediately dispose of one argument that is sometimes put forward to negate the possibility that some regulatory measures be considered as subsidies or State aids.

Consider the case of two States with two different levels of regulation (one higher, one lower) with respect to, for example, labour or environmental standards. It is sometimes observed that it would be implausible to consider a country's *omission* to enact regulation as a subsidy. [60]

In the absence of measures of harmonisation at the international level, it is indeed within the sovereignty of each State to decide what is the standard of environmental or labour protection which it sees as most appropriate to its society. Accordingly, differences in standards (and, more generally, in how regulatory regimes are drafted) between various States may well affect competition, [61] but they cannot be relevant as such for subsidy rules.

Where however it can be determined that the imposition of lower standards is not simply an omission but does in fact constitute *derogation from the general policy in the country* in favour of certain undertakings, there are no reasons why this form of deregulation may not be capable of being regarded as a form of subsidy. This issue, which revolves around the question of the limitations to sovereignty, shows an overlap between the *public intervention* and the *analysis of the advantage* granted thereby which is thoroughly analysed in the next chapter.

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[60] Benitah (2001: 70). Cf also Didier (1999: note 76 to 231).
[61] OECD (2001: 27- 28) which deals with the issues of differences in regulatory regimes, in terms of higher/lower standards and in the choice of so-called 'initial entitlements'.

## III. The forms of governmental action covered by subsidy and State aid rules

After analysing *in general* the forms of public intervention in the economy that may confer an economic advantage and the techniques to define their legal relevance, we may now proceed to answer the second question formulated at the beginning of this chapter - what action *in fact* constitutes a subsidy or a State aid - and examine the forms of governmental action covered by the two legal systems at issue. This analysis paves the way to the third issue on what action *should* be considered a subsidy or a State aid, which is mainly dealt with in the critical and comparative section of the chapter.

We thus commence with the examination of the state of the law in the WTO.

### 1. WTO law

The analysis focuses on the legal treatment of subsidies in the GATT first and in the WTO afterwards.

In so doing we concentrate on the first two techniques described above, ie the formulation of the definition and the rules of imputability which, for the sake of simplicity (mainly depending on the tight link between the two aspects in the most important provision under examination, Article 1.1(a)(1) SCM), are largely analysed together.

#### Formulations of the definition of subsidy and rules of imputability

##### The GATT era

The GATT did not include any express definition of subsidy, and hence of its main constituent elements such as the forms of governmental action covered. It is known from an early Panel report that this was not considered as 'necessary nor feasible' and that it 'would probably be impossible to arrive at a definition that would at the same time include all measures that fall within the intended meaning of

the term in Article XVI without including others not so intended'. [62] To be true, the lack of a definition depended on divergences of views. This comes out clearly from a report of a group of experts adopted one year earlier. Considering its interest, it is worth quoting it in full:

> [w]ith respect to the meaning of the word "subsidies", a large majority of the experts considered that it covered only subsidies granted by governments or by semi-governmental bodies. Three experts considered that the word should be interpreted in a wider sense and felt that it covered all subsidies, whatever their character and whatever their origin, including also subsidies granted by private bodies.

Despite this divergence, however,

> it was agreed that the word "subsidies" covered not only actual payments, but also measures having an equivalent effect.

The writer cannot but see an interesting resemblance between this conclusion and the language used by the Court of Justice a few months later when it quite ingeniously distinguished the terms 'aid' and 'subsidy' saying that the former does not cover only positive benefits (ie subsidies) but also those forms of financial support that 'are similar in character and have the same effect' of positive benefits'. [63]

Returning to the GATT, some linguistic hints against a limited coverage could be found in various provisions which alternatively referred to 'any subsidy' (Articles VI:3 and Article XVI:I GATT) or to 'any form of subsidy' (Articles XVI:3 and 4), or which noted that subsidies could be granted directly or indirectly (Articles VI.3, XVI:3 and XVI:4 GATT) or, with a particular emphasis on the effects of the measure, that they could affect imports or exports in a direct or indirect way (Article XVI.1 GATT).

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[62] Report of Panel 'Operation of the Provisions of Article XVI', BISD 10th Supp/201 (1962) paragraph 23.
[63] Case 30/59 *Steenkolenmijnen*, page 19. See below for comment.

From the beginning, the consistent reading of the term subsidy has thus been quite extensive. The Tokyo Round Subsidies Code, for instance, mentioned some 'examples of possible forms of subsidies', encompassing 'government financing of commercial enterprises, including grants, loans or guarantees; government provision or government financed provision of utility, supply distribution and other operational or support services or facilities; government financing of research and development programmes; fiscal incentives; and government subscription to, or provision of, equity capital'. [64] An examination of the disputes confirms that various measures of assistance have been regarded as subsidies (such as direct payments, capital injections, loans, debt forgiveness, credit facilities, tax deferrals and exemptions).

Although it was debated whether more complex regulatory mechanisms such as lax environmental or labour standards could also be included in the notion of subsidy, [65] it seems that, albeit comprehensive, the concept of subsidy in the GATT was limited to measures involving a clear transfer of economic resources and, in the case of action through intermediaries, requiring a quite close involvement of the government. [66] This is the interpretation arguably made by an early Panel [67] and confirmed prior to the Uruguay Round by the Group of Experts on the Calculation of the Amount of a Subsidy (a body operating under the Tokyo Round Committee on Subsidies and Countervailing Measures), which noted that

> there can be no subsidy in the absence of a financial contribution by government ... there is a necessary link between a subsidy and the taxation function of government, exercised either directly or delegated to other, private bodies. [68]

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[64] Article 11.3. We can also mention a 1960 Working Party that, during the negotiations to put the provision of Article XVI:4 fully into effect, reported a proposal of a quite detailed list of measures considered as export subsidies. Quite interestingly, it was thought it necessary to underline that 'this list should not be considered exhaustive or to limit in any way the generality of the provisions of paragraph 4 of Article XVI'. See Report 'Provisions of Article XVI:4', BISD 9th Supp/185 (1961), paragraph 5.

[65] *Pro* Bronckers & Quick (1989: 22); O'Brien (1994); *contra* Benitah (2001: 68).

[66] It was accordingly concluded that price support systems which are maintained by indirect methods such as quantitative restrictions, flexible tariffs or similar charges, would not constitute a subsidy. See Panel Report 'Review pursuant to Article XVI:4', BISD 9th Supp/188 (1961) paragraph 11.

[67] See Panel Report 'Review pursuant to Article XVI:4', BISD 9th Supp/188 (1961) paragraph 12.

[68] This view was incorporated in a Note by the GATT Secretariat on 'Subsidies and Countervailing Measures' presented during those negotiations (MTN.GNG/NG10/W/4, Section 4.1.A). It may be noted that these findings of both the Panel (ibid) and the Group of Experts anticipate, almost verbatim, the future wording of the financial contribution requirement of Article 1.1 SCM, and will play a significant role in its interpretation by the Panel, *US - Export Restraint* (see paragraph 8.71).

In particular, the concept of 'financial contribution', construed with reference to the link with the 'taxation function of the government', clearly hints at the forms involving a quite defined transfer of economic resources connected with the governmental prerogative to collect revenue and spend it. These correspond to the most commonly accepted forms of subsidy. On the other hand, the rule of imputability of the forms of indirect action shows a particularly tight degree of government involvement by using the term 'delegation'.

What emerges is therefore that there was a certain agreement that only (clear/established) forms of financial assistance would have been covered in the GATT definition of subsidy with the exclusion of (more complex) forms of regulatory measures.

## The WTO era

The regulation of subsidies in the WTO is included in two main instruments, the SCM Agreement and the Agreement on Agriculture (AoA). The analysis concentrates on two provisions which the writer considers particularly significant, the financial contribution requirement of Article 1.1(a)(1) SCM and the form of export subsidy in Article 9.1(c) AoA.

### SCM Agreement

The SCM Agreement, which constitutes the most general and important regulation of subsidies, has introduced for the first time a fairly sophisticated definition of subsidy.

In particular, under Article 1.1(a), the action by the government may be constituted of two alternative elements, a *financial contribution* or *any income or price support*, which should confer a *benefit*.

### *Article 1.1(a)(1) SCM: the financial contribution requirement*

Article 1.1(a)(1) of the SCM requires that for a subsidy to exist there must be a *financial contribution* by a government or any public body. Article 1.1(a)(1) also includes an elaborate list of various forms of financial contribution which occur where:

(i) a government practice involves a direct transfer of funds (e.g. grants, loans, and equity infusion), potential direct transfers of funds or liabilities (e.g. loan guarantees);

(ii) government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits);

(iii) a government provides goods or services other than general infrastructure, or purchases goods;

(iv) a government makes payment to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments.

For the purposes of the present analysis, the important questions to answer are the following. What are the interpretation and the role of this requirement and, in particular, of its fourth subparagraph? Does the financial contribution require a cost to government?

We now attempt to answer the first question, leaving the issue of financing to the next section.

*Interpretation and function of the financial contribution*

The Appellate Body has early underlined that the financial contribution is *separate from* the benefit and that these two elements *together* determine whether a subsidy exists. [69]

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[69] Appellate Body, *Brazil - Aircraft*, paragraph 157. See also *Canada - Aircraft*, paragraph 156.

The most interesting findings on the interpretation and the function of the financial contribution requirement can however be found in the (unappealled) report of the *US - Export Restraints* Panel. [70]

The issue before the Panel was whether an export restraint could constitute a financial contribution in the form of the government-entrusted or government-directed provision of goods in the sense of Article 1.1(a)(1)(iii) and (iv) of SCM.

For the reader's convenience, the Panel considered as an export restraint 'a border measure that takes the form of a government law or regulation which expressly limits the quantity of exports or places explicit conditions on the circumstances under which exports are permitted, or that takes the form of a government-imposed fee or tax on exports of the product calculated to limit the quantity of exports.' [71]

The core of the debate: nature v effect of governmental action

The central argument of the United States, the defendant in *Export Restraints*, which mirrored its position with respect to the notion of subsidy during the Uruguay Round negotiations, was based on an exclusive emphasis on the (beneficial) effects produced by the governmental intervention in the economy.

An export restraint can be caught by the fourth subparagraph when its *effect is to induce* domestic producers to sell their products, in greater quantities or exclusively, to domestic users. In other words, when the producer of the restrained goods has no other practical or commercial option than to sell in the domestic market, an export restraint would be *functionally or conceptually equivalent* to an entrustment or direction to that producer to provide those goods in the domestic market under Article 1.1(a)(1)(iv) SCM, the difference being merely *semantic.* In such circumstances, it would be *as if* the government had explicitly and affirmatively ordered those producers to do so.

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[70] See, in particular, the long reasoning in paragraph 8.15 to 8.76.

[71] In so doing, the Panel followed the definition proposed by the claimant, Canada. Interestingly, the US proposed a broader definition, ie 'an action or an act that holds back or prevents exports' (ibid, paragraph 8.16).

In response to the 'effects approach' advocated by the US, the Panel underlined that the determination of whether a financial contribution exists must concentrate on the examination of the *nature* of the action by the government and not on its *effects*.

The interpretation whereby, irrespective of its nature, *any* governmental action producing a certain *result* would effectively amount to a financial contribution, would eventually mean reading the financial contribution requirement out of the SCM Agreement. The Panel concluded that the focus of the financial contribution assessment must therefore be on the government's *action* rather than the possible *effects* of that action on, or the reactions to it by, those affected, even if those effects or reactions are expected. From another perspective, it was noted that the reaction of private entities to given governmental measures cannot constitute the basis of establishing that Member's compliance with WTO law.

The Panel then crucially found that the SCM Agreement regulates only certain forms of governmental action that distort or may distort international trade. [72] It is with this express purpose in mind that the definition of subsidy (with its three 'gateways': financial contribution, benefit and specificity) [73] was drafted.

Most importantly for our analysis, the *function* of the financial contribution requirement is to ensure that not all government measures that confer benefits can be deemed to be subsidies. As a necessary corollary of this function of limitation, according to the Panel, those forms should be considered as exhaustive.

Although a different reading of the financial contribution requirement has been advanced, [74] the construction made by the *US - Export Restraints* Panel seems to be correct.

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[72] This would significantly be in line with the object and purpose of the SCM Agreement. See in particular Panel, *Canada - Aircraft*, paragraph 9.119; Panel, *Brazil - Aircraft*, paragraph 7.26.

[73] Strictly speaking, the specificity test is not part of the definition of subsidy in the SCM Agreement. See Articles 1.2 and 2.1 SCM.

[74] McGovern (1994: 11.31-3) shows that, whereas, on the one hand, the four modes of subsidy under point (a)(1) are introduced by the phrase 'i.e. where' (thus suggesting the exclusiveness of the list), on the other hand, point (a)(1)(iv) refers to the 'functions *illustrated* in (i) to (iii) above (thus indicating the contrary). The author concludes by noting that 'it would be unfortunate if they were found to constitute a comprehensive definition'. We believe that the function of limitation of the financial contribution requirement is particularly clear from the introducing phrase 'i.e where'. In our view, the conflicting term 'illustrated' is just a remnant of the very first draft of the provision which was introduced by 'such as where'. Whereas the latter was subsequently replaced by 'ie' and eventually by the final form 'ie where', in our view the former term remained untouched due to a clear oversight.

The limiting role of the financial contribution element has been substantially confirmed by the following jurisprudence. After underlining that 'Article 1.1(a)(1) *makes clear* that a "financial contribution" by a government or public body is an *essential component* of a "subsidy"', [75] the Appellate Body has recognised that 'paragraphs (i) through (iv) of Article 1.1(a)(1) set forth the situations *where there is* a financial contribution by a government or public body'. [76] Consequently, 'not all government measures capable of conferring benefits would necessarily fall within Article 1.1(a)' as, otherwise, there would be no need for the financial contribution 'because all government measures conferring benefits, *per se*, would be subsidies'. [77]

In the light of the previous construction of the financial contribution element, the *function* of the fourth subparagraph is not to encompass forms of action other than those provided in subparagraphs (i) to (iii), and consequently to enlarge the coverage of the definition of subsidy, but rather to avoid circumvention of those subparagraphs by a government simply acting through a private body (or, indeed, through a funding mechanism). [78] Using a particularly illuminating expression, the Panel noted that that provision has to do with the identity of the *actor* and not with the *nature* of the actions covered by the financial contribution requirement.

It may finally be noted that, according to the Panel, all forms of financial contribution involve a clear transfer of economic resources in the form of a transfer of something of value, either money, goods or services, from the government or an intermediary to a private entity. Crucially, as a consequence of the function of limitation of the financial contribution, we should note that the converse is not necessarily true, that is *not* all transfer of economic resources constitute a financial contribution under the SCM Agreement.

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Further, a restrictive, albeit not necessarily an 'exclusive', approach seems to be confirmed by the *coda* to subparagraph (iv) which makes it clear that the conduct of the intermediary 'would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments'.

[75] Appellate Body, *US - DRAMS*, paragraph 107 (emphasis added).

[76] Ibid, paragraph 108 (emphasis added).

[77] Appellate Body, *US - DRAMS*, paragraph 114 building on its finding in *US - Softwood Lumber IV*, note 35 to paragraph 52. See also Panel, *EC - DRAMS*, paragraph 7.58.

[78] This anti-circumvention function has been confirmed by the Appellate Body. See *US - DRAMS*, paragraph 113; *US - Softwood Lumber IV*, paragraph 52.

Subparagraph iv) between restrictiveness and expansiveness

The reader has certainly noticed the inherent - and intriguing - tension between two findings. On the one hand, the *restrictiveness* of the conclusion that subparagraph (iv) cannot extend the coverage of the financial contribution - which is just a corollary of the general finding that the *function* of the financial contribution requirement is to limit the forms of governmental action regulated thereunder.

On the other hand, the natural *expansiveness* of any mechanism to counter circumvention - which has been recognised as the true *function* of subparagraph (iv).

What is crucial, then, is to find an appropriate *balance* between these two objectives, a point of equilibrium between these two conflicting forces.

Any legal norm is subject to interpretation. As such, any legal provision is very much comparable to a valve that controls the passage of a given substance. As the exposition of the various interpretations made by dispute settlement organs will show, this is particularly true for the rules of imputability under the fourth subparagraph. Depending on which of the two objectives indicated above prevail (limited coverage v anti-circumvention of the financial contribution), more or less courses of conduct will 'pass' through the valve, thus enlarging or restricting the scope of the financial contribution requirement and, consequently, of the definition of subsidy.

Our proposition is that, according to the prevailing canons of interpretation of the Vienna Convention, the balance between the two tendencies described above has *mainly* to emerge from - and be consistent with - the text of the financial contribution requirement itself.

The quest for a balance: the development of the law

What we see with respect to the financial contribution through a private party can appropriately be viewed as a quest for a balance between the two opposing trends indicated above. We commence with an examination of the development of the law with respect to the relevant rules of imputability.

In *US - Export Restraints*, the US were substantially claiming that the key factor in the interpretation of the terms 'entrust' and 'direct' was the proximity of the causal relationship between the action by the government and the conduct of the private body (an export restraint would thus fulfil the required 'direction' when the producer of the restrained goods has no other choice but to sell in the domestic market).

In its disagreement, the Panel gave a restrictive interpretation of those two terms. The ordinary meanings of the concepts of 'entrust' and 'direct' necessarily conveyed an idea of 'explicit and affirmative action [of] delegation or command'. [79]

A first step towards a more liberal interpretation can be found in the recent *US - DRAMS*, *Korea - Commercial Vessels* and *EC - DRAMS* Panels (for simplicity, hereinafter referred to as 'the Panels'). While they agreed that the terms 'entrust' and 'direct' must respectively contain an element of delegation or command, and that they should invariably take the form of an affirmative act, they disagreed as to whether they necessarily need to be *explicit* insofar as they could be 'explicit or implicit, informal or formal'. [80]

Finally, most recently, in the *US - DRAMS* dispute the Appellate Body made a significant step further by rejecting that the concepts of entrustment and direction be limited to the notions of delegation or command.

On the one hand, the concept of entrustment would generally be connoted by an *action of giving responsibility* to someone for a task or an object. This interpretation is not limited to acts of delegation, either formal or informal, as there may be other means, be they formal or informal, that governments could employ to give responsibility to carry out one of the functions listed in paragraphs (i) to (iii) of Article 1.1(a)(1) SCM. [81]

On the other hand, the Appellate Body found that the notion of direction is connected with the *exercise of governmental authority* over a private body. A command is certainly one way which a government can use to exercise such authority, but,

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[79] Panel, *US - Export Restraints*, paragraphs 8.29-8.30.
[80] Panel, *US - DRAMS*, paragraph 7.33; Panel, *EC - DRAMS*, paragraph 7.57; Panel, *Korea - Commercial Vessels*, paragraph 7.470.
[81] Appellate Body, *US - DRAMS*, paragraph 110.

most significantly, there are equally other means which may be used, some of which are *more subtle* or *may not involve the same degree of compulsion.* [82]

The quest for a balance: analysis of the law

After exposing the state of the law, we may now attempt to explain these interpretations in the light of the observations that have been made with respect to the two conflicting objectives within the financial contribution element, and the need to strike an appropriate balance between them.

The main concern, and hence the focus, of the *US - Export Restraints* Panel was to show that the financial contribution requirement only covers certain forms of public intervention. It is against this background that the admittedly strict interpretation of the tests of imputability under subparagraph four (which would require the explicitness of the action) can be properly understood.

In the following cases, we notice a shift in emphasis. The role of delimitation of the financial contribution was not an issue. [83] What we have is the attempt to give an *effective* interpretation to the anti-circumvention device of the fourth subparagraph.

Thus the Panels underlined that to require that the action of delegation and command be *always explicit* would undermine the utility of Article 1.1(a)(1)(iv) as it would enable governments to circumvent their commitments. [84] In *US - DRAMS*, the Appellate Body searched the essence of the terms 'entrustment' and 'direction' which it found in the broad concepts of conferral of responsibility to or exercise of authority over somebody. In so doing, it eventually rejected the assimilation with the notions of delegation and command.

This final outcome (entrustment and direction are respectively different from delegation and command), however, raises some concerns.

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[82] Ibid, paragraph 111. As regards the complexity of the act of entrustment or direction, it may also be noted that, unlike all previous dispute settlement organs, the Appellate Body did not request that the action of the government be *affirmative*.

[83] Cf Appellate Body, *US - DRAMS*, paragraph 114; *US - Slumber IV*, note 35 to paragraph 52; Panel *EC - DRAMS*, paragraph 7.58

[84] Panel, *US - DRAMS*, note 50 to paragraph 7.33, *Panel, Korea Commercial Vessels*, footnote 209 to paragraph 7.370; Panel *EC - DRAMS*, footnote 65 to paragraph 7.57.

This may well be illustrated by the analysis of the Appellate Body's construction of the term 'direct' (a similar exercise could be entertained with the interpretation of 'entrust').

Using the traditional approach, the writer commences with the ordinary meaning of the word set in its immediate context. In particular, the choice of the appropriate meaning of 'direct' would be significantly influenced by the syntax of the phrase 'direct a private body to carry out'. Thus, in our view, to direct somebody to do something cannot but mean to *order* him or her to do something. [85] The examination of the meanings of the corresponding verbs in the French and Spanish versions (respectively 'ordonner' and 'ordenar'), when inserted in similar structures ('ordonner à quelq'un de faire quelque chose'; 'ordenar a alguien que lleve a cabo algo'), [86] would confirm the conclusion that the phrase at issue refers to an *'order to* somebody *to* do something'. [87]

The textual interpretation of 'direct' thus refers to a course of conduct, which might well be 'explicit or implicit, informal or formal' as it was found by the Panels, but which is necessarily characterised by a *well defined - and rather marked - degree of direction* and *compulsion* in the governmental action.

Crucially, this interpretation sits uneasily with the conclusion of the Appellate Body that a *command is not necessary* and that even forms of action that are *more subtle* or that *not involve the same degree of compulsion* are covered. [88]

We are aware that legal interpretation does not exclusively depend on grammatical analysis. The already underlined importance of the textual approach in the WTO however requires that the letter of the law should not be *emptied.*

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[85] For a similar reading cf Panel, *US - Export Restraints*, paragraph 8.28.

[86] See *Diccionario de la lengua española* e *Nouveau Petit Robert.*

[87] It may be recalled that, according to Article 33(3) of the Vienna Convention, '[t]he terms of the treaty are presumed to have the same meaning in each authentic text'.

[88] It is worth noting that the Appellate Body too started its analysis from similar dictionary meanings of to 'direct' ('give authoritative instructions to' and 'order (a person) to do').
Although, probably, envisaging two different forms of conduct, the Appellate Body itself seems to have recognised that the degree of compulsion required by the term 'direct' is the same of the term 'mandate' (which undoubtedly means 'command' or 'order'). This finding was made in the context of the interpretation of the phrase 'governmental action' in Article 9.1(c) AoA. See *Canada - Dairy (Article 21.5 - New Zealand and US II)*, paragraph 128: 'Article 9.1(c) does not require that payments be financed by virtue of government '*mandate*', or other '*direction*'. Although the word 'action' certainly covers situations where government mandates or directs that payments be made, it also covers other situations where no such compulsion is involved' (emphasis in the original).

An excessively extensive interpretation of subparagraph iv) inevitably risks expanding too much the scope of the financial contribution requirement and thus endangering the balance between its two consolidated functions of limitation and anti-circumvention. We have already suggested that if a balance between two conflicting objectives has to be struck, this has to be consistent with the letter of the law. In this regard, it is interesting to compare for a moment the Appellate Body's construction with the reading made by the Panels. There is no doubt that the latter is *textually* more correct and is hence more successful in achieving an appropriate balance.

Interestingly, the Appellate Body concludes its reasoning by underlining that its interpretation is in line with the object and purpose of the SCM Agreement, which, using its words, 'reflects a delicate balance' between those Members that sought more discipline on the use of subsidies and those that sought more discipline on the application of countervailing measures. [89] This general statement is certainly correct, and will be quite useful for our analysis, in particular when we attempt to make some conclusive remarks on the coherency of the definition of subsidy in the WTO. Nevertheless, it does not address our more *specific* concerns about the (different) *balance* between the two conflicting objectives of limitation and anti-circumvention that have emerged from the analysis of the financial contribution, concerns that are also motivated by the need to fully respect the text and hence the object and purpose of the SCM Agreement.

Even assuming, for the sake of the analysis, that the Appellate Body's novel interpretation of the term 'direct' is correct, we are not left with a clear guidance on the applicable standard. The Appellate Body itself recognises that difficulty when it hastens to add that the relevant determination 'will hinge on the particular facts of the case'. [90]

The fact remains that the actual meaning and impact of the *general* finding that the concept of direction refers to situations where the government exercises its authority over a private body on the more *specific* finding that this may be more

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[89] Appellate Body, *US - DRAMS*, paragraph 115.
[90] Appellate Body, *US - DRAMS*, paragraph 116.

subtle than a command and does not necessarily involve the same degree of compulsion is still difficult to capture.

With an express reference to the *nature* of the form of intervention, the Appellate Body has emphatically ruled out that the interpretation of paragraph (iv) can be so broad as to cover measures whereby governments merely exercise their 'general regulatory powers'. [91] In our view, it is however still an open question whether, on the basis of the more liberal interpretation of the term 'direct' (and the same could equally be said for the term 'entrust'), quite complex *regulatory* mechanisms, such as those involving lax labour or environmental standards or import and export restraints, could now fall – at least under certain circumstances - within the scope of the provision. [92]

Finally, it cannot pass unnoticed that, despite the Appellate Body's stated intention, the proposed liberal interpretation has the potential to weaken the finding that the financial contribution focuses on the *nature* and not on the *effects* of the action of the government. The more we leave clear notions such as command, moving towards more subtle and less intense courses of action, the more there is a risk that the financial contribution be defined on the basis of the *circumstances of the case* and the *behaviour of third parties.* [93]

*Brief parallel with the other form of action (payments to funding mechanism)*

We may finally say a few words on the other form of action provided for under the fourth subparagraph of Article 1.1(a)(1) SCM where 'a government makes payments to a funding mechanism'.

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[91] Ibid, paragraph 115.

[92] We leave aside other possible obstacles to the inclusion in the financial contribution requirement. In some cases, for example when the government *fully* exempts the undertakings concerned from any environmental requirement, it may be difficult to identify a clear transfer of economic resources from the suppliers of environmental devices or services and consequently to determine which form of financial assistance is at issue (provision of goods? transfer of funds?). In other cases, such as in the case of labour standards, it can really be disputed that by its own nature the measure cannot be performed by a government (government cannot be *employed* and provide *employment services*) and, as such, cannot be covered by paragraph (iv).

[93] Citing the *US - Export Restraints* Panel, the Appellate Body confirmed that entrustment and direction cannot cover 'the situation in which the government intervenes in the market in some way, which may or may not have a particular result simply based on the given factual circumstances and the exercise of free choice by the actors of the market'. Government entrustment or direction 'cannot be inadvertent or mere by-product of governmental regulation' (*US - DRAMS*, paragraph 114).

The meaning of the two terms 'funding' and 'mechanism' is rather apparent and does not need much clarification. The provision refers to those cases where the government makes payments to a system *that is established to transfer financial resources* to entitled categories. [94]

It has been said that the two forms of indirect action under the fourth subparagraph 'are aimed at capturing *equivalent* government actions'. [95]

The correctness of this assimilation is however put into question by the recent interpretation of the term 'entrust' in the other form of indirect action which, according to the Appellate Body, would not necessarily refer to an act of delegation. If this is correct, the financial contribution through a funding mechanism would arguably be characterised by a more direct and intense course of action than the entrustment of a private body to carry out a financial contribution. The government makes a payment to a funding mechanism which – unlike any other private body - is there *exclusively to finance* somebody, and hence any payment received from the government should almost automatically be used for such mission.

*Conclusions*

The concept of financial contribution as formulated by the SCM Agreement, and as interpreted by the dispute settlement organs, seems to partly depart from the notion of subsidy that can be derived from the GATT.

Although the financial contribution generally seems to refer to well-defined and commonly agreed forms of governmental action involving a clear transfer of economic resources, the most recent Appellate Body findings on the standards of imputability in the case of indirect action have created a bit of uncertainty raising the question of whether also more complex regulatory mechanisms, which have so far been excluded, could now be covered. [96]

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[94] It is interesting to mention the very similar wording used by the GATT Panel Report 'Review pursuant to Article XVI', in BISD, 9th Supp/188 (1961) paragraph 12.

[95] Panel, *US – Export Restraints*, paragraph 8.32..

[96] The previous, consistent interpretation was that the financial contribution requirement would preclude regulatory measures from being covered. See Benitah (2001: 68-74); Jackson (1997: 296); Beviglia-Zampetti (1996: 28). A dissenting view, under GATT rules, is provided by O'Brien (1994) and Bronckers and Quick (1989).

It has been suggested that the concepts of 'direction' and 'entrustment' in subparagraph (iv) should be construed so that the action of the government should involve a marked degree of direction and compulsion. This interpretation, which is the most consistent with the text of the financial contribution requirement and is thus capable of striking an appropriate balance between its functions of limitation and anti-circumvention, would limit the possibility of extending the scope of the provision to more complex courses of action.

***Article 1.1(a)(2)SCM: any income or price support – an additional concept in search for an expansive reading***

According to Article 1.1(a)(2), a subsidy shall be deemed to exist when there is 'any form of income or price support in the sense of Article XVI of GATT 1994'.

Income and price supports are forms of government intervention aimed at sustaining the income of a certain category or at maintaining the price of a certain commodity at a given, usually a minimum, desired level. [97]

Before analysing the actual scope of Article 1.1(a)(2), in terms of forms of action covered and rules of imputability, we should immediately underline that, to do justice to its separate mention and hence to its utility, this provision should *naturally* regulate measures *different* from those considered as financial contribution under Article 1.1(a)(1). This has also been expressly confirmed by the Appellate Body when, after setting forth the 'financial contribution' and the various forms of government action disciplined in the four subparagraphs of Article 1.1(a)(1), it noted that '[t]his range of government measures capable of providing subsidies is *broadened still further* by the concept of "income or price support" in paragraph (2) of Article 1.1(a)'. [98]

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[97] This formulation largely corresponds to the entries 'income support' and 'price support' that can be found in the Black's Dictionary of Economics (2002: 225 and 336). The phrase 'in the sense of Article XVI of GATT 1994' means that the measure must operate to increase exports of the product benefiting from the subsidy or decrease the imports of competing products. In our view, this refers to the *effect* of the subsidy, that is to the strengthening of the beneficiary of the subsidy and, ultimately, to the consequent increase of its exports or decrease of its competitors' imports.

[98] *US - Softwood Lumber IV*, paragraph 52 (emphasis added).

Having said that, what is really interesting is the definition of the *actual scope* of the expression 'any income or price support'. In this regard, it may be useful to draw a parallel with our previous findings on the financial contribution.

One reading would indicate a quite restrictive coverage. An early GATT Panel focused on price-support schemes and 'discussed the circumstances under which a system which fixes domestic prices to producers at above the world price level might be considered a subsidy in the meaning of Article XVI'. [99] The Panel emphasised that there could be cases in which a government maintained a fixed price without resort to a subsidy, ie without a loss to the government. One example would be the case of a minimum price fixed by law 'which is maintained by quantitative restrictions or flexible tariff or similar charges'.

What is interesting to note is that one of those cases where 'a government maintained a fixed price above the world price without resort to a subsidy' was considered by the Panel in *US - Export Restraints*. That Panel noted that the support of the price of a commodity by imposing high tariffs on imports would not constitute subsidies within the meaning of Article 1. In particular, it is doubtful whether the 'concept of financial contribution contained in Article 1.1(a)[1] of the SCM Agreement seeks to bring such government action within the ambit of the SCM Agreement'. [100]

Now, the comparison between the findings of the GATT Panel and the *US - Export Restraints* Panel seems to highlight a high degree of similarity with respect to the degree of government involvement required by the criteria of financial contribution and of income or price support. In other words, it would seem that, although producing a transfer of economic resources, complex regulatory mechanisms involving border measures, such as tariffs and export restraints, cannot be caught within the scope of either provision.

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[99] Panel Report based on a review pursuant to Article XVI:4, BISD 9th Supp (1961), 188, at paragraph 11.
[100] Panel Report, *US - Export Restraints*, paragraph 8.38. It may be useful to recall that, in that dispute, the Panel was actually analysing whether, an export restraint, a practice similar to a tariff but with complementary effects (by limiting exports, export restraints increase the quantity of goods produced domestically and decreases its price; by limiting imports, tariffs decrease competitive pressure from outside the domestic market and hence contribute to maintain a certain price level), was covered by subparagraph (iii) read in conjunction with subparagraph (iv).

There are however various indications in support of a more expansive reading of Article 1.1(2)(a) SCM. They are partly based on a textual interpretation of the provision, and partly based on a trend made evident by the recent jurisprudence on the definition of the public intervention.

On the one hand, unlike the financial contribution requirement, the phrase 'any income or price support' is not limited to specific forms of governmental action. On the contrary, its general wording is capable of encompassing various forms of public intervention that may be deployed to execute *any* income or price support. Further, there is no express qualification of the standard of government involvement required. Therefore, it is not difficult to imagine that that phrase could catch also more complex regulatory measures that would not constitute a financial contribution.

On the other hand, we can draw inspiration from some recent findings on the more sophisticated language of the financial contribution requirement. Leaving aside for the moment the issue of the loss to government, which the GATT Panel required for price support schemes (and which, as we will see, is probably not good law anymore) it is interesting to focus on the recent relaxation of the rules of imputability of the financial contribution by the Appellate Body in *US - DRAMS*. This interpretation has already been extensively examined (and criticised) because it does not completely fit with the text of subparagraph iv) of Article 1.1(a)(1) SCM.

Irrespective of its (in)correctness, it is however interesting to appreciate in the context of our analysis the more liberal approach towards the degree of government involvement requested. This is particularly so if this approach is more liberal than that of the *US - Export Restraints* Panel which we have found to be rather similar to the early GATT interpretation of price support schemes.

The conclusion may be that, according to various indicators, the tide might be changing. With its potentially broad language, the phrase 'any income or price support' may well include complex regulatory measures, such as those involving border measures, which were originally considered not to be covered (and which, arguably, still remain outside the scope of the financial contribution requirement).

### *AoA and SCM Agreement: about definitions and relationships*

In the context of our current analysis, the most striking difference between the AoA and the SCM Agreement is that the former does not include any definition of subsidy.

Some direction can however be found if we consider the relationship between the two agreements.

As has been made evident by some recent disputes, particularly *EC – Sugar* and *US –Cotton*, the relationship between AoA and SCM Agreement is particularly complex.

To some extent it can certainly be described as one between *lex specialis* on the one hand and *lex generalis* on the other. The SCM Agreement, which applies to any sector of the economy (except for services and agriculture), would thus represent the general discipline of subsidies. Its *generality* is arguably reflected in the primary provisions, of which the best example is that of basic definitions. In other words, whereas there may well be differences between the SCM and other instruments or provisions regulating subsidies (which determine the latter's *speciality*), it may be argued that these seem to concern mainly the actual *discipline* rather than the most fundamental provisions such as those defining basic concepts.

However, things are more complex, in particular because of the various references, or cross-references, between the two instruments. Looking at the SCM, for example, apart from Article 3 (which generally reads 'except as provided by the AoA': along the same line, but with a more general language, see Article 21.1 AoA), other provisions such as Articles 5, 6 and 7 expressly referred to the application of Article 13 AoA, the so-called 'peace-clause', which, for a few years, somewhat protected subsidies otherwise in compliance with the requirements of the AoA from the application of the SCM disciplines. The peace-clause itself, in the writer's view, was evidence of a relationship of 'ancillarity' of the AoA towards the SCM. Now that its shelter is gone, probably the relationship between the two agreements will be clearer. Article 21.1 AoA, with its general wording which seems to confirm the 'speciality' of the AoA's discipline, is however still there.

The previous statements, and doubts, find some confirmation in the case-law. Under certain circumstances (and, in particular, when defining the notion of 'subsidy'), it may be appropriate to look at the SCM for contextual guidance when interpreting the AoA. The Appellate Body itself interpreted the term 'subsidy' by drawing, as context, upon the definition of subsidy – and in particular both elements of financial contribution and benefit - in Article 1.1 SCM. It accordingly observed that a subsidy involves a transfer of economic resources from the grantor to the recipient for less than full consideration. [101]

Further, according to the Appellate Body itself in *US – Cotton*, since these two instruments are 'integral parts of the same treaty [the WTO Agreement]', they should be read harmoniously. [102] *EC – Sugar* was somewhat more complicated than *Cotton* because what was at issue there was not the *alternative* but rather the *cumulative* application of the two agreements. [103] Many issues of relationship therefore remain open.

Having said that, we should highlight that the absence of a definition of subsidy does not mean that the provisions of the AoA are completely irrelevant for *definitional purposes*. In fact various provisions offer valuable indications with respect to the *forms of public intervention* covered under that agreement and hence to their characteristic elements.

### *Article 9.1 AoA*

This is, for example, the case of Article 9 AoA which encloses a list of export subsidies concerning scheduled products which are subject to reduction commitments. In these provisions the legislator has usefully described many features of the forms of governmental action covered.

Leaving aside for the moment Article 9.1(c), we may make some brief remarks on the forms covered by these provisions and highlight their specificity. Either because of their formulation or because their anchorage to the definition of financial

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[101] *Canada - Dairy*, paragraph 87; *US - FSC*, paragraph 136.
[102] *US – Cotton*, paragraph 549.
[103] See paragraph 339: 'the question of applicability of the SCM Agreement to export subsidies causes a number of complex issues'.

contribution of Article 1.1 SCM, *all* those provisions seem to encompass measures of financial assistance featuring a clear transfer of economic resources. Depending on the formulation of the provision, they may involve only a direct or also an indirect course of action. Most interestingly, with respect to the cases of indirect conduct, the relevant rules of imputability seems to involve different degrees of intensity (from the more demanding one embodied in the term 'mandate' in subparagraph e) [104] to the potentially more comprehensive one expressed by the word 'provide' in subparagraph d)). [105]

### *Domestic support*

Analogously, the examination of the discipline of domestic support measures offers some indications with respect to the characteristics of the forms of action that are regulated as domestic subsidies. [106]

For example, it seems that most of the measures of domestic support involve a transfer of economic resources. [107] It is moreover clear that, at least in some cases, domestic support may also be granted indirectly.

An interesting issue concerning indirect action is whether also less immediate actions of support, such as those carried out through border measures (think of the case of export restraints) can be covered.

The AoA distinguishes between import quotas and other non-tariff border measures on the one hand and forms of domestic support, including income and price

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[104] Subparagraph e) regulates internal transport and freight charges on export shipments, provided or mandated by governments, on terms more favourable than for domestic shipments. It may be noted that the verb 'to mandate' is particularly clear (it means 'to command' or 'to order'; see Shorter Oxford English Dictionary (2002: vol I, 1688) and, consequently, cannot raise the sort of interpretative doubts that we have seen with respect to the verb 'direct' in Article 1.1(a)(iv) SCM.

[105] Subparagraph d) refers to the provision of subsidies to reduce the costs of marketing exports of agricultural products and the costs of international transport and freight. The verb 'provide' features 'to make available' among its various meanings (Shorter Oxford English Dictionary (2002: vol II, 2382)

[106] We may safely assume that the term 'support' is very similar in meaning to 'subsidy'. Even a quick scan through the various meanings of the verbs 'to support' and 'to subsidise' shows a great deal of similarity: see Shorter Oxford English Dictionary (2002: vol. II, 3090 and 3119). After a comprehensive analysis of the AoA, the *US - Cotton* Panel has explained that 'all relevant types of support for the purposes of the *Agreement on Agriculture* are subsidies' (see paragraphs 7.420 to 7.423). The equation support-subsidy is especially evident from Annex 3 to the AoA, on the methodology to calculate aggregate measurement of support, and in particular at paragraphs 1 and 2 thereof.

[107] See, for example, Articles 6 and Annexes 2, 3 and 4.

support measures, on the other. [108] While the former are treated under the 'market access' chapter and assimilated to tariffs, the latter are subject to a different regulation. [109] Article 4 on 'Market Access' provides that Members shall not maintain, resort to, or revert to any measures of the kind which have been required to be converted into ordinary customs duties. These measures include various examples of border measures. [110]

The Appellate Body has made it clear that these measures should have been converted into ordinary customs duties before the entry into force of the WTO Agreement and thus subject to the same mechanism of liberalisation constituted of bindings and reductions. [111] Crucially, if they have not been converted, they could not be maintained and, hence, they should be regarded as prohibited. [112] Now, the important issue is whether border measures, which have not been converted into tariffs and are thus prohibited under Article 4, could be regarded as measures of domestic support.

We will now concentrate on the form of subsidy under subparagraph (c) of Article 9.1 AoA, concentrating in particular on its interesting rule of imputability.

***The rule of imputability in Article 9.1(c) AoA***

Article 9.1(c) of the Agreement on Agriculture subjects to reduction commitments 'payments on the export of an agricultural product that are financed by virtue of governmental action, whether or not a charge on the public account is involved'.

This provision is particularly interesting for its rule of imputability, and in particular for the phrase 'financed by virtue of governmental action', which the Appellate Body thoroughly analysed in the three stages of the *Canada - Dairy* dispute.

In the original proceedings, governmental agencies played a crucial role at every stage of the supply of cheaper milk with the result that there was no difficulty in

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[108] As seen, export subsidies are regulated in a separate part (V) of the AoA.
[109] The Agreement on Agriculture provides for reduction commitments of domestic support measures.
[110] A footnote mentions 'quantitative import restrictions, variable import levies, minimum import prices, discretionary import licensing, non-tariff measures maintained through state-trading enterprises, voluntary export restraints and other similar border measures other than ordinary customs duties'
[111] Cf Appellate Body, *Chile - Price Band System*, paragraphs 206 and 207.
[112] Cf ibid, paragraph 207.

concluding that the payment took place 'by virtue of governmental action'. After a substantial deregulation of the market for export milk, the regulatory framework under examination in the two Article 21.5 DSU proceedings was more elusive. The Appellate Body had thus the opportunity to concentrate more extensively on the various elements of the standard of imputability.

The phrase 'governmental action' is 'somewhat open-ended, perhaps even abstract', with the result that that provision 'extends, in principle, to *any* governmental action whereby the government 'regulate', 'control' or 'supervise' individuals. [113] On its part, the word 'finance' refers 'generally to the mechanism or process by which financial resources are provided to enable "payments" to be made'.

What is crucial in the definition of the standard of imputability is the determination of the nexus between the governmental action and financing which is indicated by the phrase 'by virtue of'. This would require that

> there must be a demonstrable link between the *governmental action* at issue and the *financing* of the payments, whereby the payments are, in some way, financed as a result of, or as a consequence of, the governmental action. [114]

The Appellate Body underlined that 'it is extremely difficult ... to define in the abstract the precise character of the required link between the governmental action and the financing of the payments'. [115] It then noted:

> [g]overnments are constantly engaged in regulation of different kinds in pursuit of a variety of objectives. For instance, we can envisage that governmental action might establish a regulatory framework merely enabling a third person freely to make and finance 'payments'. In this situation, the link between the governmental action and the financing of the payments is too tenuous for the 'payments' to be regarded as 'financed' by virtue of governmental action' (emphasis added) within the meaning of Article 9.1(c). Rather, there must be a tighter nexus between the mechanism or process by which the payments are *financed*, even if by a third person, and governmental action. In our opinion, the

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[113] *Canada - Dairy, (Article 21.5 - New Zealand and US II)*, paragraphs 129 and 131; *Canada - Dairy (Article 21.5 - New Zealand and US)*, paragraph 112.
[114] *Canada - Dairy (Article 21.5 - New Zealand and US)*, paragraph. 113.
[115] Ibid, paragraph 115.

existence of such a demonstrable link must be identified on a case-by-case basis, taking account of the particular governmental action at issue and its effects on payments made by a third person. [116]

Most importantly, according to the Appellate Body, the existence of a 'demonstrable link' does not necessarily require the exercise of compulsion. Article 9.1(c) 'does not require that payments be financed by virtue of government '*mandate*', or other '*direction*'. Although the word 'action' certainly covers situations where government mandates or directs that payments be made, it also covers other situations where no such compulsion is involved'. [117] In this regard, the first Article 21.5 DSU review Panel noted that 'by virtue of' does not refer only to those cases where obedience is 'enforced' but also those where action is simply 'influenced' as 'in both instances the result would not occur *but for* the power to enforce or influence'. In other words, 'whether the government "forces" or merely "encourages" producers to sell into the commercial export market are *qualifications* of the causal relationship required under Article 9.1(c)'. [118]

*A parallel between the rules of imputability in Article 9.1(c) AoA and Article 1.1(a)(iv) SCM*

We may now attempt to draw a parallel between Article 9.1(c) AoA and that under Article 1.1(a)(iv) SCM.

It may be immediately noted that the two provisions have a different approach with respect to the forms of governmental action that are covered. In both systems it is necessary to have a transfer of economic resources. Whereas, however, the financial contribution element under Article 1.1(a)(1) SCM encompasses only certain forms of governmental action, Article 9.1(c) AoA in principle extends to any governmental action (the only notable qualification being that we are dealing with *export* subsidies).

The analysis becomes particularly interesting if we concentrate on the rules of imputability under those provisions.

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[116] Ibid. See also *Canada - Dairy (Article 21.5 - New Zealand and US II)*, paragraph 134.
[117] *Canada - Dairy (Article 21.5 - New Zealand and US II)*, paragraph 128 (emphasis in the original).
[118] *Canada - Dairy Products (Article 21.5 - New Zealand and US)*, paragraphs 6.35 and 6.44 (emphasis in the original).

If we look at the findings of the jurisprudence of the Appellate Body we find contradictory indications.

On the one side, it is said that neither provision requires a high degree of compulsion, in the form of, respectively, a 'mandate' or 'direction', [119] or 'delegation' or 'command'. [120] The same reports, however, provide in the small print of the footnotes conflicting indications when expressly comparing the rule of imputability under Article 1.1(a)(1)(iv) SCM and that under Article 9.1(c) AoA. Whereas in the second implementation report in *Canada – Dairy*, Article 9.1(c) AoA has been 'contrasted' to Article 1.1(a)(1)(iv) SCM to explain that the former does *not* require a standard of attributability *as high as* that of the latter, [121] in *US - DRAMS* the Appellate Body interpreted Article 1.1(a)(1)(iv) by making an express reference to Article 9.1(c) thus suggesting that, in its view, the two standards of imputability *are substantially comparable.* [122]

A closer scrutiny seems to show that the two standards of imputability do *not* have the same scope.

We have highlighted that the relaxed interpretation of the Appellate Body of the term 'direct' still leaves a great deal of uncertainty and suggested that, to avoid that the letter of the law is emptied, it is still necessary to require a well-defined degree of direction and compulsion.

That is not necessarily the case with respect to the phrase 'financed by virtue of governmental action'. Although it is not easy to define the required 'demonstrable link' with certainty, it seems clear that it is broader than that of the SCM provision both in terms of i) complexity of the causal nexus (encompassing even less direct actions) and of ii) intensity of the action (including also actions of encouragement). [123]

Further, comparing the two standards of imputability, we somewhat see the passage from a *more formalistic* approach, whereby only certain, well-defined, forms of action

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[119] *Canada - Dairy (Article 21.5 - New Zealand and US II)*, paragraph 128.
[120] *US - DRAMS*, paragraphs 110 and 111.
[121] Footnote 113 to paragraph 128.
[122] Footnote 184 to paragraph 114.
[123] In the context of Article 1.1(a)(1)(iv) SCM, the Appellate Body made it clear that mere policy pronouncements and mere acts of encouragement cannot be enough (*US - DRAMS*, paragraph 114).

are relevant, to a *more sophisticated* one, where what matters is not the classification of the form of intervention but rather a more comprehensive analysis of its impact in the context of the circumstances of the case (including the behaviour – or reaction - of the affected parties).

**_Abstract_ rules of imputability: the definitions of government agency and public body**

The definitions of government agency under Article 9.1(a) AoA and of public body under Article 1.1(a)(1) SCM are two good illustrations of a particular technique to determine whether the conduct of a public entity is imputable to the government.

Article 9.1(a) AoA subjects to reduction commitments export subsidies that consist of 'the provision by governments and their agencies of direct subsidies, including payments-in-kind'.

The Appellate Body noted that

> [t]he essence of "government" is ... that it enjoys the effective power to "regulate", "control" or "supervise" individuals, or otherwise "restrain" their conduct, through the exercise of lawful authority. This meaning is derived, in part, from the *functions* performed by a government and, in part, from the government having the *powers* to perform those functions

The Appellate Body then turned to the notion of 'government agency' and found that it referred to 'an entity which exercises powers vested in it by a "government" for the purpose of performing functions of a "governmental" character'. [124] The key elements were therefore the delegation by the government of powers and the performance of functions of governmental character. By contrast, the fact that the agency enjoyed a certain degree of discretion in the exercise of its duties and that it was composed, completely or partially, of individuals representing production sectors was not relevant.

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[124] *Canada - Dairy*, paragraph 97.

The most important indication of *Canada - Dairy* is that the operation of the rule of imputability underlying the action through governmental agencies seems to simply rely on the *classification* of the body as 'government agency'. In this process, the degree of influence of the government is certainly considered but at a rather *general* and *abstract* level with the result that the *standard of imputability* is rather strict. In a word, once a given body is found to be a 'governmental agency', virtually every instance of its conduct is caught by the discipline.

Interestingly, the phrase 'financial contribution by a government or any public body' in the *chapeau* of Article 1.1(a)(1) SCM can be read in a similar fashion.

The SCM Agreement provides for a clear distinction between 'public' and 'private bodies'. This distinction is particularly relevant in the context of Article 1.1(a)(1) SCM as different parts of the provision, and in principle different rules of imputability, may be applicable. The *US - Export Restraints* Panel has indicated that any entity that is neither a government nor a public body would be a private body. [125] As the notion of private body is residual (and we may assume that the meaning of government is the same as that provided in the AoA), we may focus on the concept of 'public body'. The *Korea - Commercial Vessels* Panel has recently made it clear that

> an entity will constitute a "public body" if it is controlled by the government (or other public bodies). If an entity is controlled by the government (or other public bodies), then any action by that entity is attributable to the government and should therefore fall within the scope of Article 1.1(a)(1) of the *SCM Agreement.* [126]

It is clear that this definition, with its general reference to the *control* exercised by the government, leaves many interpretative issues open. There may be cases where the boundaries between the concepts of 'public body' and 'private body' are not easy to draw. We can for example think of the case of public undertakings that can be generally defined as those undertakings that are *under the control of* the government. Should they be regarded as public bodies? Some fine-tuning may be required with

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[125] *US - Export Restraints*, paragraph 8.49

respect to the notion of control. This leads to the second remark. We should ask whether the assimilation between 'public bodies' and 'government' (which is explicitly made by Article 1 SCM) should indicate that further elements should be considered in order to define an entity as a 'public body' and, in particular, whether these should be represented – as in the definition of governmental agency in Article 9.1(a) AoA - by the *conferral of public powers for the performance of governmental functions.*

The most significant observation is, however, that the test emerging from the phrase 'financial contribution by a government or any public body' is remarkably similar to that of the phrase 'provision by government and their agencies of direct subsidies' in Article 9.1(a). What seems to be required is a general and abstract assessment of the control of the government.

***A brief parallel between abstract and concrete rules of imputability***

We may conclude our examination of the rules of imputability by comparing the *abstract* rules emerging from the expressions 'government or any public body' and 'governments and their agencies' with those resulting from the fourth subparagraph of Article 1.1(a)(1) SCM and Article 9.1(c) AoA. When compared with the former the latter can certainly be defined as *concrete.*

Whereas the two cases regulated under the fourth subparagraph of Article 1.1(a)(1) SCM and Article 9.1(c) AoA *describe the action* of the government, the phrases 'financial contribution by a government and any public body' and 'provision by governments and their agencies of direct subsidies' put a considerable stress on the *definition of the agent*: the government, the public body or a government agency.

This structural characteristic plays an important role in the definition of the rules of imputability.

Under the *chapeau* of Article 1.1(a)(1) SCM and Article 9.1(a) AoA, the crucial interpretive step is the classification of the body under scrutiny *as* a 'public body' or a 'government agency'. In this regard, general considerations, such as those concerning the *statute* or the *nature of the body*, or the *general control or influence by the*

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[126] *Korea - Commercial Vessels*, paragraph 7.50.

*government*, certainly play a more important role than the *assessment of the government influence actually exercised in the case at issue* which is, by contrast, required – albeit in different ways - under Article 1.1(a)(1)(iv) SCM and Article 9.1(c) AoA.

The crucial consequence is that, since they feature rules of imputability which are *more or less strict*, the relevant provisions are accordingly *more or less comprehensive* with respect to the forms of public intervention that they cover. For example, a more rigorous rule of imputability (eg an abstract one) will make it more likely that the conduct at issue is covered. Conversely, a less rigorous rule of imputability (eg a concrete one) can make it less likely that the conduct is caught. This is however only the result of the comparison between what the writer has dubbed as abstract v concrete rules of imputability. In fact, particularly when the rules of imputability focussing on the *action* of the government are considered, various standards (again more or less demanding) can be found.

## The origin of the resources

We now examine the regulation of subsidies in the GATT/WTO by focusing on the third technique to define the legal relevance of the public intervention, that is the origin of the resources used to finance the subsidy. The last technique - the objective of the measure - is considered afterwards by analysing WTO law and EC law together.

It is worth commencing with a terminological premiss.

### Premiss on definitions: costs between economics and accounting

When discussing the financing of a subsidy, various concepts have been used in the GATT and in the WTO such as 'financial contribution', 'charge on the public account', 'budgetary expenditure', 'loss of public revenue', 'loss or cost to government', 'governmental resources'. It is therefore particularly important to clarify immediately these concepts and see what their relationship, if any is.

The notion of 'financial contribution' is rather ambivalent. It may equally refer to the *action* of the government that transfers economic resources, as we have seen in the first part of this chapter, and to the governmental *origin* of the resource. 'Budgetary expenditure' and 'charge on the public account' [127] seem to refer to the use of public revenue which, according to accounting rules (and practices), is recorded in the public accounts. By way of simplification, it can be said that these accounts usually take note of actual expenditure (such as a payment), potential expenditure (such as guarantees), and capital loss (such as when revenue, like a credit, is waived). By contrast, the expressions 'loss of public revenue' and 'loss or cost to government', [128] which can indeed be compared to that of use of 'governmental resources', are more general, and include any form of financing involving government resources irrespective of whether any trace is left in the public accounts. In particular, they can be construed so extensively as to include

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[127] The latter is commonly used in the legislation. Cf Article 9.1(c) of the Agreement on Agriculture and item (l) of the Illustrative List of Export Subsidies enclosed, as Annex I, to the SCM Agreement. Cf also the GATT Panel Report 'Operation of the Provisions of Article XVI' adopted on 21 November 1961, GATT, 10th Supp BISD 201 (1962), paragraph 5.

also the costs in the *economic* sense, that is *opportunity costs* in the form of, for example, foregone interests.

As Begg, Fischer and Dornbusch (1997: 6-94) explain, the concept of *opportunity cost*, which can be distinguished from that of *accounting cost*, is the one that is particularly significant in economic terms. It is the amount lost by not using the resource at hand, such as capital, in its best alternative use. In other words, whereas this economic concept is concerned with the best allocation of available resources, the accounting notion of cost is focused on the actual payment made by a firm which should leave a trace in its accounts. [129]

In sum, whereas some concepts (eg 'loss' or 'cost to government' and 'governmental resources') are more concentrated on the *economic* substance of the matter, others are more connected to the *accounting* side.

All the concepts above are however used indifferently and the meaning that prevails is the actual or potential use of governmental resources, whether noted or not on the public accounts (in the remainder of the analysis we will mainly use the expression 'cost to government'). It may be useful to anticipate that also the concept used in the EC ('grant through State resources') focuses on the actual use of government resources, or, with another term, on a financial burden, rather than on budget recording.

Once it is accepted that a cost to government is necessary, the crucial issue from a legal standpoint is to determine whether, in the case at hand, this has been incurred.

**The GATT era**

One of the most controversial issues in the debate on the definition of subsidy has always been whether a cost to government is necessary.

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[128] The expression 'loss to government' can be found in the GATT Working Party Report 'Provisions of Article XVI:4' adopted on 19 November 1960, GATT, 9th Supp BISD 185 (1961), paragraph11.
[129] In our context, the issue of opportunity costs usually arise when it has to be determined whether 'soft loans' amount to a subsidy. This occurs when, for example, the government lends money to an undertaking at an interest rate (say 9%) that is above the rate at which the government borrows (say 8%) but below the relevant rate in the private market (say 10%). The government can be said to have incurred an opportunity cost by 'giving up a portion of the interest it *could* obtain': Jackson (1997: 295).

Different views have been adopted and defended along the years by the various Contracting Parties, in particular the US (traditionally arguing that a cost to government is not necessary) and the EC (claiming, by contrast, that it is a necessary requirement). The conflict sparked during the 'Steel War' between US and EC in the early 1980s. [130] The clash perpetuated itself through the Uruguay Round negotiations and was eventually settled in the WTO era.

The official position on the issue of the GATT was difficult to ascertain.

Whereas no significant indication has been offered by the disputes, various reports of the early 1960s substantially lend support to the view that a cost to government was in any event necessary. [131] The Tokyo Subsidy Code does not feature a definition of subsidy and hence does not include any definitive answer on the issue either. It has sometimes been argued that the requirement of a cost to government in substance emerged from its annexed Illustrative List of Export Subsidies. [132] The language used in most of the examples of export subsidy (such as 'provision', 'allowance', 'exemption', 'remission', 'deferral', 'drawback', 'grant') seems to suggest the use of public resources. [133] A particular confirmation of this reading seems to derive from the closing item (l) which, by referring to '*any other charge on the public account* constituting an export subsidy' (emphasis added), was read as indicating a common denominator of all the previous examples.

Interestingly, this has also been the view taken by the European Court of Justice in the two *Fediol* cases decided in the late 1980s. The Court noted that the various items of the Illustrative List on Export Subsidies, and in particular the last item (l), justified the fact that 'in the mind of the Community legislature [ie Regulation No

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[130] Bronckers & Quick (1989: 17) refer to the 1981/1982 so-called 'steel war' between US and EC as the first point in time when the latter argued for the necessity of a cost to government.

[131] See the Panel Report 'Review pursuant to Article XVI:5' adopted on 24 May 1960, GATT, 9th Supp. BISD (1961), page 188, paragraphs 11 (on price support schemes) which refers to 'loss to the government' and 12 (on the action through intermediaries) which underlines the importance of the 'source of the funds'. See also the incidental recognition that subsidies would involve a charge on the public account in Panel Report 'Operation of the Provisions of Article XVI' adopted on 21 November 1961, GATT, 10Th Supp. BISD (1962), page 201, paragraph 5.

[132] See Beseler & Williams (1986: 123-124). *Contra* Bronckers & Quick (1989: 14). The illustrative list is a revision of a list included in a 1960 Working Party Report (Report on the 'Provisions of Article XVI:4' adopted on 19 November 1960, GATT, 9th Supp. BISD (1961), page 185, paragraph 5), and is substantially reproduced in Annex I of the WTO SCM Agreement.

[133] Admittedly, some support to the opposite argument could be found in item c) which, by simply referring to measures 'mandated' by government, is broad enough to cover also transfers financed with private resources.

2176/84 implementing the Tokyo Subsidy Code] the concept of export subsidy necessarily implied a financial burden borne directly or indirectly by public bodies'. [134]

The fact is, however, that the Tokyo Round Code did *not* solve the issue. The reliance on the Illustrative List, for example, is not decisive because it merely refers to some examples of *export* subsidies and not to the definition of *subsidy* itself.

A close reading of the *Fediol* decisions shows that the Court of Justice itself was aware of this.

It rejected the more affirmative arguments of the Commission and the Advocate General. The former distinguished the concept of GATT subsidy from that of State aid, which at the time did not involve a financial burden for the State. The latter went even further arguing that, 'although unsupported by rules of Community or international law', it is 'semantically and logically indisputable' that the requirement of cost to government is inherent in the notion of subsidy.

The Court more cautiously found that

> '[t]he concept of subsidy thus understood is *not incompatible* with the Community's obligations under international law, in particular under GATT and agreements concluded in the framework thereof'. [135]

The Court pointed out that, *in GATT law, there has never been an express definition of the term 'subsidy'*. Accordingly, the Commission

> 'was *not wrong or arbitrary* in concluding that the concept of subsidy in Article 3 of Regulation No 2176/84 presupposes the grant of an economic advantage through a charge on the public account'. [136]

The conclusion that the Community was *entitled* - but *not required* - to take the view that a charge on the public account was necessary in its countervailing duty law

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[134] See paragraph 11 of Case 187/85; paragraph 12 of Case 188/85.
[135] Paragraphs 12 of Case 187/85; paragraphs 13 of Case 188/85. Emphasis added.

cannot simply be justified by the usual deferential approach in the judicial review of Community's acts. It is more intriguingly the Court's acknowledgement that the choice of EC countervailing duty law was just an *option*, permitted by the GATT. The latter did not provide for an express definition of subsidy and hence a final word on the cost to government issue.

**The WTO era**

In the analysis of the cost to government issue in WTO law, the writer mainly concentrates on the definition of subsidy in Article 1 SCM, and in particular on the financial contribution. The SCM is the most general regulation of subsidies in the WTO and it is with respect to the definition of subsidies therein that there was a fierce confrontation during the Uruguay Round.

The situation is different with respect to agriculture. It seems indeed that the issue of the financing of subsidies has not been equally controversial in the context of the AoA.

In some cases, it is the actual provision that seems to indicate that there is no need that government resources are used. We may recall Article 9.1(c) AoA which regulates payments financed by virtue of governmental action, '*whether or not a charge on the public account is involved*'. [137]

In other cases, this may be easily inferred, for example with respect to the forms of domestic support that do not fulfil the condition of Article 1(a) Annex 2 (that is that 'the support in question shall be provided through *a publicly-funded programme (including government revenue foregone) not involving transfers from consumers*'). [138] In other cases, for example Article 9.1(a) ('provision by governments or their agencies of direct subsidies, including payments-in-kind'), the dispute settlement has made it clear that

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[136] Paragraphs 13 of Case 187/85; paragraphs 14 of Case 188/85. Emphasis added.
[137] See Appellate Body, *Canada - Dairy (Article 21.5 - New Zealand and US)*, paragraph 114; id, *Canada - Dairy (Article 21.5 - New Zealand and US)*, paragraphs 132 and 133.
[138] Emphasis added. That might be the case of a parafiscal charge imposed on consumers or even on producers at large.

there is no need for a transfer of government resources [139] and, quite probably, the relevant findings can be transposed also to other items of Article 9.1. [140]

### *The SCM Agreement*

*The financial contribution: unresolved compromise or creeping victory?*

The two opposite views on the cost to government issue, and, more generally, on the definition of subsidy, confronted with each other during the Uruguay Round negotiations and were mainly heralded by the United States on one side and the European Communities on the other. [141] The former's more extensive approach contrasted with the stricter approach of the latter.

In particular, along with Australia, the United States position was very much 'effect-oriented'. It proposed that subsidy be defined as 'any measure or combination of governmental measures which confers a benefit on the recipient enterprises'. [142] According to this view, which corresponds to the broad approach to the definition of subsidies in US countervailing duty law history, [143] what matters is the distorting effect of the measure and not its form or how it is financed.

Together with other negotiating countries, the European Communities counter-argued that 'actions by public authorities which do not imply expenditure of public funds, or, anyway, a charge on the public account, are not subsidies and thus *a fortiori* cannot be actionable or be otherwise subject to subsidies discipline'. [144] The concern was that the omission of such requirement would be that an indefinite number of measures would be caught.

The *chapeau* of Article 1.1(a)(1) SCM provides that, for a subsidy to be deemed to exist, it is necessary to have 'a financial contribution by a government'. Then we have a list of three forms of financial assistance and a provision, item (iv), which

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[139] See Panel, *Canada - Dairy*, paragraph 7.56.
[140] Consider, for example, paragraphs d), e) and f).
[141] See McDonough (1993: 898-899); see also Didier (1999: 230-233).
[142] GATT Document MTN.GNG/NG10/W/29.
[143] Cf the footnotes at page 899 of Stewart. *cit.*
[144] Cf GATT Document MTN.GNG/NG10/W/31.

envisages that the government may make the financial contribution through intermediaries, such as a private body.

Commencing with the expression 'financial contribution', although the negotiating history shows that it has often been regarded as a synonymous to cost to government, [145] taken in itself, its meaning remains uncertain. Moreover, the wording of item (iv) of Article 1.1(a)(1) SCM, which disciplines also the case where 'a government entrusts or directs a private body to carry out' a financial contribution, is capable of encompassing also those cases where the transfer of economic resources is not actually financed by the government but rather by the intermediary.

The scope of Article 1.1(a)(1) SCM is thus ambiguous. What is however interesting to ask is *how* this ambiguity *can be justified.* On the one hand, it can be advanced that it is the necessary price for reaching an agreement between two very different positions. More bluntly, it is the result of an *unresolved compromise.* In this light, since both the expression 'financial contribution', and the wording of item iv), are vague enough to accommodate both positions, Article 1.1(a)(1) SCM would have been simply postponed the solution of the issue. On the other hand, it may well - and has - been argued that the ambiguity of the provision, and in particular its capability to include the more extensive position, should be read as the *creeping victory* of the latter.

Bourgeois (2001: 220-221) has reported that the scholars' views on which position ultimately succeeded diverge. Some suggest that a cost to government would not be necessary. [146] Low (2001: 111) suggests that the 'financial contribution' in Article 1.1(a)(1) SCM implies a 'financial outlay' by the government. Along the same lines, others seem to suggest that an important implication of the new definition may be

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[145] This is well illustrated in the Secretariat's note MTN.GNG/NG10/13, page 4. If we wanted to carry out this exercise through the various documents we would find that this equivalence is expressly made by Japan (MTN.GNG/NG/W27, page 2) and can almost certainly be inferred from the words of Canada (MTN.GNG/NG/W25, page 4). Some doubts might be entertained with respect to India's position (MTN.GNG/NG/W16, page 1; MTN.GNG/NG/W 33, page 3).

[146] McDonough (1993: 899), points out that the language of Article 1.1(a)(1)(iv) SCM 'apparently encompasses' the forms of 'private subsidies' 'wherein benefits are conferred on recipients from private sources but at the direction or mandate of government'. Cf also Didier (1999: 232- 233) who underlines that 'the dispute on the financial contribution concept was settled by a compromise which reflects, in the main, the US position'. As regards the term 'financial contribution', 'while excluding non financial contributions' he

to prevent the use of the SCM Agreement to attack 'regulatory subsidies' (ie the failure of governments to provide certain levels of regulation, such as environmental protection or labour standards) which, as seen in the introduction, often do not involve any cost to the government. [147]

The Appellate Body has unravelled this ambiguity. Before setting forth its findings, it may however be worth saying a few words on the other limb of Article 1 SCM which concerns the public intervention and which, like the financial contribution, raises an issue of financing.

*Article 1.1(a)(2): forms of income or price support*

The 1960 GATT Panel report concluded that, under Article XVI GATT, only 'price support' measures requiring a 'loss' to the government could be regarded as subsidies. [148] This interpretation is consistent with the general position as to the definition of subsidy and the cost to government issue prevailing in the GATT.

Article 1(a)(2) SCM now regulates 'any form of income or price support in the sense of Article XVI of GATT 1994'. The issue of whether measures of income support can be fully assimilated to those of price support may be left aside. The interesting question is whether the new provision should be interpreted as the GATT Panel did with Article XVI GATT, or, rather, whether a new reading is possible, particularly if the general position with respect to the issue were changed with respect to other forms of public intervention, notably those provided in the financial contribution.

It does not seem that this point has been discussed during the Uruguay Round negotiations. Some support for the more extensive interpretation can be found in the literature. Low (2001: 111) argued that, whereas 'income and price supports will often imply a financial outlay of some kind by the government', it is indeed possible to devise a minimum price regime which does not involve a financial outlay and which would certainly distort trade in a GATT 1994 Article XVI sense.

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argues that it seems 'sufficiently wide to encompass many forms of State intervention which have financial consequences, whether or not they imply a call on the public purse'.

[147] Jackson (1997: 296); Benitah (2001: 71 and 73-74).

[148] GATT Panel Report adopted on 24th May 1960 (Review pursuant to Article XVI:5 GATT), BISD 9th Suppl 1961 188, at p. 191.

As anticipated, a more liberal position would definitely be strengthened by a more general finding that the definition of subsidy in general no longer requires a cost to government. This point - the *prevailing* interpretation of the 'financial contribution' requirement – is analysed in the next paragraph.

*Unravelling the ambiguity of the financial contribution: Canada - Aircraft*

The wording of Article 1.1(a)(1) SCM does not expressly indicate whether a subsidy requires a cost to government is required but is ambiguous on this point. Whatever reading is given to the resulting ambiguity - as we have suggested, either unresolved compromise or creeping victory - it was predictable that, sooner or later, the issue would have been subject to the scrutiny of the newly-established dispute settlement organs for a decision. What, arguably, was not fully predictable is the direction that would have been taken.

The issue of whether a 'cost to government' is relevant in the context of Article 1.1(a) of the SCM was raised in the *Canada - Aircraft* dispute. The context of the debate, however, was not the interpretation of the 'financial contribution' element in Article 1.1(a)(1) but rather the definition of the 'benefit' under Article 1.1(a)(2). In particular Canada was arguing that the notion of 'cost to government' is relevant in the interpretation of the term 'benefit' within the meaning of the latter. By rejecting the argument, the Panel noted that

> if "benefit" were to include the notion of net cost to government, it could exclude from the definition of "subsidy" situations explicitly identified in Article 1.1(a)(1) itself as constituting government financial contributions even though no cost to the government might be involved. Specifically, Article 1.1(a)(1)(iv) identifies as a "financial contribution" the situation where a government directs a private body to make "financial contributions" within the meaning of Article 1.1(a)(1)(i)-(iii). In such a situation, the net cost could be incurred entirely by the private body rather than the government. Canada's interpretation of "benefit" (i.e., to include net cost to government) would render Article 1.1(a)(1)(iv) meaningless, since a form of "financial contribution" explicitly included in Article 1.1(a) would automatically (i.e., because it would never meet the net cost to government test) be excluded by Article 1.1(b). [149]

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[149] *Canada - Aircraft*, paragraphs 9.115.

Although the argument of effectiveness is arguably over-marked (the consideration that the alternative reading 'would render Article 1.1(a)(1)(iv) *meaningless*' seems to want to prove too much), the position of the Panel is unmistakably clear.

Albeit with a more laconic language, the Appellate Body confirmed that a 'cost to government' is not implied in the context of the 'financial contribution'. It crucially observed that Canada's argument, whereby the concept of 'cost to government' would be relevant in the interpretation of the 'benefit',

> would exclude from the scope of that term those situations where a 'benefit' is conferred by a private body under the direction of government. These situations cannot be *excluded* from the definition of 'benefit' in Article 1.1(b), given that they are specifically *included* in the definition of 'financial contribution' in Article 1.1(a)(iv). [150]

These findings are highly significant, [151] not only in the context of the financial contribution requirement. This interpretation may have a spill-over effect with respect to a more a more extensive reading of the other form of government intervention concerning 'any income or price support'.

The only regret is that this controversial issue was not raised in its natural context - the financial contribution - thus requiring the dispute settlement organs to provide a full reasoning. The importance of the conclusion, however, cannot be underestimated, quite the contrary. Both the Panel and the Appellate Body were certainly fully aware of the long-standing debate on the cost to government issue and of the importance of any, even though incidental, finding on the issue.

*Exercise of interpretation: the issue in the context of the financial contribution*

The challenging goal of this paragraph is to test the conclusion of the Panel and the Appellate Body on the cost to government issue by addressing it in its natural context - the financial contribution requirement - and by using the 'customary rules

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[150] *Canada - Aircraft*, paragraph 161.

of interpretation', ie the criteria indicated by the Vienna Convention (VCLT) which have been thoroughly analysed in the previous chapter. In other words, this section offers an *exercise* of interpretation.

For the reader's convenience, the 'general rule' of interpretation of Article 31.1 VCLT may be repeated: 'a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose'. According to Article 32 VCLT, this may be complemented by the use of supplementary means of interpretation, such as the preparatory works, in order to confirm the discovered meaning or to determine it when the general rule has left it ambiguous or obscure.

Among all these hermeneutic instruments we have already underlined the centrality of the textual approach, ie of the interpretation of the ordinary meanings of the words of the provision. Having this in mind, we make use of other relevant tools of interpretation which may be, expressly or implicitly, derived from those provisions.

Textual and contextual interpretation

We have already said that the expression 'financial contribution' is not fully clear.

A quick check of the dictionary meanings of the constituent elements of 'financial contribution' indicates that this expression substantially refers to a payment, ie to a transfer of *financial* or *economic* resources. Whereas 'financial' means 'of or pertaining to revenue or money matters', [152] the examination of the most relevant dictionary meanings of 'contribution' ('something paid or given (voluntarily) to a common fund or stock; an action etc. which helps to bring about a result; the action of contributing') [153] seems to indicate that the meaning conveyed by the phrase 'financial contribution' essentially refers to *a payment*, which is most probably executed to reach a particular aim.

This is in line with findings of our previous analysis of financial contribution which led us to conclude that it refers to forms of action that involve such *financial* transfer.

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[151] For a more recent confirmation see Panel, *US - Export Restraints*, note 167 to paragraph 8.73.
[152] *Shorter Oxford English Dictionary* (2003: Vol I, 959).
[153] *Shorter Oxford English Dictionary* (2003: Vol I, page 506).

What is not however equally clear is that this definition would necessarily refer to the origin of the resources involved. Although the phrase 'financial contribution' has often been used as a synonymous of cost to government or charge on the public account, that does not seem to be its main *focus* and its wording is actually general enough to encompass also cases with no use of governmental resources. This conclusion finds confirmation if we concentrate (as immediate context) on one form of financial contribution, that embodied in the fourth paragraph of Article 1.1(a)(1) SCM which regulates the case where the government entrusts or directs a private party to carry out one of the previous forms of action and which (as the dispute settlement organs in *Canada - Aircraft* have already noted) is certainly capable of encompassing transfers of economic resources which are actually provided by the intermediary, and not by the government.

The results of our textual/contextual analysis are therefore that:

a) the expression 'financial contribution' seems mainly to refer to the *action of transfer of financial resources*, and not to the *source* of the latter,

b) this definition does not necessarily refer to the origin of the resources, particularly the fourth item of Article 1.1(a)(1) SCM.

We do not find any other contextual guidance, in support of or against, our reading either in other provisions of the SCM or in other WTO instruments.

On the one hand, provisions such as Article 14 SCM or Article 1 of Annex IV to the SCM Agreement, which are mentioned by Didier (1999: 232), are not relevant because, in our view, they are not appropriate context in the interpretation of the financial contribution requirement. The former refers to the concept of *benefit* (more particularly, to the calculation of the amount of the subsidy for countervailing duty actions), the latter to the (now expired) presumption of *serious injury* under Article 6.1(a) SCM.

On the other hand, the interpreter might be tempted into looking at similar definitional provisions of other WTO instruments, such as the AoA. Irrespective of

the fact that these do not provide unequivocal indications, the most fundamental obstacle is of systematic nature. The reference to a *specific* discipline (on agriculture), may be of limited help when we should interpret the *general* discipline of subsidies (such as the SCM Agreement), and in particular its *express* general definition thereof.

Interpretation 'in the light of the object and purpose' of the treaty

Some support to our textual (and contextual) interpretation - Article 1.1(a)(1) generally refers to a transfer of economic resources provided by the government but not to its method of financing - could arguably be found in the analysis of the object and purpose of the SCM Agreement.

The object and purpose of the treaty should mainly be derived from its text, and in particular its preamble which usually spells out the background and the objectives of the relevant discipline.

However, as a clear evidence of the considerable disagreement on the 'subsidy issue', the SCM Agreement does not have a preamble. The dispute settlement organs have thus been cautious in defining the object and purpose of the SCM Agreement, and formulating arguments based on it. [154] What can usually be found are general statements which summarise it as the establishment of a multilateral discipline on the premiss that some forms of government intervention distort international trade, or have the potential to distort international trade, or, with an alternative more laconic formulation, as a multilateral discipline on subsidies which distort international trade. [155]

Admittedly, along with the *US - Export Restraints* Panel, we might underline that the SCM Agreement does not regulate 'every government intervention that might in economic theory be deemed a subsidy with the potential to distort trade'. [156] Along these lines, it would be concluded that Members wanted to regulate only those forms of governmental action that *involve* a cost to government.

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[154] It has been noted that 'the SCM Agreement does not contain any express statement of its object and purpose. We therefore consider it unwise to attach undue importance to arguments concerning the object and purpose of the SCM Agreement'. Cf Panel, *Canada - Aircraft*, paragraph 9.119.
[155] The two definitions can respectively be found in Panel, *Canada - Aircraft*, paragraph 9.119, and Panel, *Brazil - Aircraft*, paragraph 10.11.
[156] Panel, *US - Export Restraints*, paragraph 8.62.

Another reading is however possible. Despite the caution underlined above, a certain degree of agreement on the purpose of the subsidy discipline can be reached. By relying on the consideration that subsidies are regulated because they cause, or may cause, *distortions*, it could indeed be suggested that no relevance should be given to a factor, the financing of the measure, which, *in general*, does not seem to be relevant to capture its distorting potential.

Admittedly, certain conduct, such as predation (ie under-cost selling), are more likely to be successful if they draw from the resources of the clearly deep pockets of public coffers. This, however, does not lend any support to considering the cost to government as a *necessary* requirement of the definition of subsidy, It merely indicates that, in some cases, the fact that a practice is publicly subsidised should be taken into due account when the impact of the measure is analysed because of its more likely danger to the competitive process.

Effectiveness, preparatory works, restrictive interpretation

Arguments on the basis of the principle of effectiveness, which, as we have seen, directly flow from 'good faith' and 'the object and purpose of the treaty' under Article 31(1) VCLT, do not seem to substantially shift the balance as they would not add any more weight to the arguments already based on purposive interpretation.

Quite similarly, we do not consider that the recourse to the preparatory works may be useful to confirm our reading. The general reservations with respect to the utility and reliability of this method have already been underlined. This is particularly true in the case at issue. The negotiating history can only tell us that there was a heated debate but are silent on whether one of those positions in the end prevailed and, if so, which one.

We may conclude by just underlining the irrelevance of the increasingly criticised principle of restrictive interpretation (*in dubio mitius*). In this regard, it is sufficient to refer to our analysis in the previous chapter.

## Conclusion

The result of the exercise of interpretation is that, on balance, the conclusion of the dispute settlement organs that the financial contribution - and *more specifically* the fourth subparagraph of Article 1.1(a)(1) SCM (it should be recalled that this was the provision interpreted by the Appellate Body) - does not necessarily involve a cost to government, is substantially supported by an interpretation of the natural context of the issue, the financial contribution requirement, and 'in accordance with the customary rules of international law'. This conclusion seems to essentially rest on a textual interpretation since the other usual tools have not provided any useful indication.

## 2. EC law

This section deals with questions similar to those that have been analysed in the previous one on WTO law. Following the first three techniques to define the legal relevance of the conduct of the government that we have set forth above (formulation of the definition, standards of imputability, origin of the resources), the attempt is to analyse the forms of governmental action that are covered by State aid rules, and in particular by Article 87(1) EC.

### Formulation of the definition of State aid

Unlike in WTO law, in the EC there is only one provision featuring the definition of State aid. Article 87(1) EC regulates 'any aid granted by the State or through State resources in any form whatsoever'.

### Broad language between potentially wide coverage and prevailing interpretation

Even on a first reading, it seems clear that this provision should not be interpreted formally or narrowly. The wording refers to '*any* aid' 'in *any* form *whatsoever*' which is 'granted by the State *or* through State resources'. Many linguistic elements thus hint towards a particularly comprehensive reading, broad enough to cover various forms of governmental action that provide for assistance to undertakings. Crucially, what is underlined here is merely the *capacity* of the definition of being interpreted broadly which does not necessarily, and always, corresponds to its *prevailing interpretation*.

A potentially broad interpretation was arguably in the minds of the fathers of the EC Treaty as comes expressly out in various points of the *Spaak* Report which underline the irrelevance of the form of the public intervention:

> Les aides accordées par les Etats doivent être examinees de très près, *indépendamment de la forme extérieure qu'elles revêtent* ... La règle générale est que sont incompatibles avec le marché commun les aides, *sous quelque forme qu'elles soient accordées* ...

The potential of State aid control has been immediately captured by the European Court of Justice. In 1961 already, it had to interpret the expression 'aid or subsidy' in Article 4(c) ECSC. In a finding, which has become a standard also in the context of Article 87(1) EC, it held that the concept of aid is wider than that of a subsidy

> because it embraces not only positive benefits, such as subsidies themselves, but also interventions which, in various forms, mitigate the charges which are normally included in the budget of an undertaking and which, without, therefore, being subsidies in the strict meaning of the word, are similar in character and have the same effect. [157]

The subsequent case law of the Court of Justice has consistently confirmed the rather open-ended coverage of Article 87(1). The Court has thus found to constitute State aids various forms of governmental assistance such as direct grants, loans, guarantees, exemptions from taxes and social contributions, under-price sales, purchases at market price but in extremely large quantities, equity injections, provision of market research and advertising activities or logistical and commercial assistance, payment of outstanding wages or redundancy costs, exemption from the normal application of insolvency rules allowing companies owing debts to public bodies to continue trading, renegotiations of debts or credit waivers.

This rather broad coverage seems to be favoured by an interpretation which puts emphasis on the *effects* of the conduct at issue. This has already been seen in the *Steenkolenmijnen* decision. In another *locus classicus*, the Court of Justice put it down even more clearly:

> [Article 87] does not distinguish between the measures of State intervention by reference to their causes or aims but defines them in relation to their effects'. [158]

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[157] Case 30/59 *Steenkolenmijnen*, page 19. Cf also ibid., at 27.
[158] Case 173/73 *Italy* v *Commission*, paragraph 13.

Along these lines it has more recently been said that the concept of State aid is an objective one. [159]

Moreover, the Court of Justice has repeatedly stated that Article 87(1) EC covers not only measures granted by the State (which does not include only central national authorities but also regional and local ones), [160] but also by other bodies which, in one way or another, are under its control.

The Court made it clear that State aid law regulates all subsidies threatening the play of competition coming from the public sector, [161] a notion that generally refers to 'that part of the economy or an industry that is controlled by the government'. [162] This notion of public sector clearly reminds the definition of 'public undertaking' adopted in Transparency Directive whereby a public undertaking is 'any undertaking over which the public authorities may exercise directly or indirectly a dominant influence by virtue of their ownership of it, their financial participation therein, or the rules which govern it'. [163]

With a broader language, the Court has also held that Article 87(1), which merely refers to any aid 'granted by the State or through State resources', should be construed so as to cover subsidies granted directly by the State as well as those granted indirectly by public or private bodies established or appointed by the State to administer the aid. [164]

## The boundaries

Despite this openness, what emerges from the case-law is that Article 87(1) EC has boundaries and that attempts to extend its application will not necessarily be warranted.

On the one hand, the Court has put some clear limits to the inherent expansiveness of a purely *effect-based* analysis. It has accordingly been made clear that there is no

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[159] Case T-67/94 *Ladbroke Racing* v *Commission*, paragraph 52.
[160] Cf, eg, Case 248/84 *Germany* v *Commission*, paragraph 17.
[161] Cf Case C-305/89 *Italy* v *Commission*, paragraph. 13; Joined Cases C-27-73/91 *Sloman Neptun*, paragraph. 19; Case T-358/94 *Air France* v *Commission*, paragraph. 56.
[162] Black's Law Dictionary (1999: 1246); an almost identical meaning can be found in the Shorter Oxford Dictionary (2003: Vol. II, 2394).
[163] See Article 2(1)(b) of the Commission Directive 80/723/EEC.

such concept as that of a 'measure having an effect equivalent to state aid'. Although, this finding does not preclude the possibility of interpreting Article 87(1) EC extensively, it certainly draws a line. On the basis of the general duty of co-operation imposed on Member States by Article 10 EC, the scope of other rules of competition law, which are addressed to undertakings, can exceptionally be extended to cover the anti-competitive conduct of Member States. This is not the case for State aid rules which are already specifically addressed to a certain type of anti-competitive conduct of Member States.

It is interesting to compare the similarity of the conclusion of the Court – there is no such concept as that of measure having an effect equivalent to State aid - with the findings in the *US - Export Restraints* dispute where the Panel rejected the attempt to extend the scope of the financial contribution requirement of Article 1.1(a)(1)(iv) SCM to other forms of action that produce a similar effect.

On the other hand, the case law of the Court of Justice has made clear that certain *forms* of public assistance with a more or less clear regulatory element are not generally caught by State aid rules (price fixing; lax labour/social law; insolvency law). [165] The reasoning underlying these decisions is not however fully clear. On the one side, there is a heavy emphasis on the lack of *use of State resources* (which, under the current state of EC law, is required of any State aid). On the other side, it may well be that in certain cases the *regulatory nature* and/or the *objectives* of the measure at issue have played a role in the decision.

By contrast, it does not seem that the negative answer depends on the fact that in these cases it is not always possible to identify a clear *transfer* of economic resources since what Article 87(1) EC simply requires is that the public action confers an economic *advantage*. Similarly, as the next section shows, it does not seem that the imputability of the measure under scrutiny to the State was an issue.

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[164] Case 78/76 *Steinicke* v *Germany*, paragraph 21; Case 290/83 *Commission* v *France*, paragraph 14.
[165] See, for example, Case 82/77 *Van Tiggele*, Joined Cases C-72/91 and C-73/91 *Sloman Neptun*, Case C-189/91 *Kirsammer-Hack*, Joined Cases C-52/97, C-53/97 and C-54/97 *Viscido*, Case C-200/97 *Ecotrade*, Case C-295/97 *Piaggio*, Case C-379/98 *PreussenElektra*, Case C-59/03 *Ciglio*la.

## Rules of imputability under Article 87(1) EC

The coverage of Article 87(1) EC is virtually quite broad encompassing various forms of financial assistance by governments. One element which contributes to such wide coverage is the possibility that public intervention conferring an economic advantage be carried out through an intermediary. In such cases the main issue is the rule of imputability.

### No precise rule of imputability

It may immediately be underlined that, unlike Article 1.1(a)(1)(iv) SCM, Article 87(1) EC does *not* provide for a detailed rule of imputability. The provision at issue here simply requires that the aid be 'granted by the State or through State resources'. Leaving aside the issue of financing, this wording has been construed in a liberal fashion, to encompass many cases where the government provides financial support indirectly. Crucially, there does not seem to be a *precise* rule of imputability but, as we are about to see, what seems to prevail is a rather *flexible* approach.

The main question of imputability occurs when the State uses a public, and all the more so a private, body as a vehicle to grant aid. What is crucial to determine then is whether the action of that body, which may well act independently, should in fact be attributed to the State.

In some cases the direction of the State, and hence the imputability of the measure, is particularly clear. The State may for example introduce legislative or administrative measures requiring the provision of assistance. [166] It may also specifically establish or appoint a public or private body to administer the aid or, in any event, give an order or an instruction to grant it.

There is also another special case where, at least in principle, the imputability seems to be rather clear-cut. We have seen that in some cases of deregulation the governmental direction operates in a peculiar way inasmuch as it immediately empowers the beneficiary, for example by exempting it from certain standards, and

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[166] Although the State aid point was not discussed by the Court, this was the clear situation in Case 21/88 *Du Pont de Nemours Italiana* where the provision in Italian legislation that required public bodies and companies to

the third party, which effectively provides the financing, is affected only rather indirectly. However, some examples of these measures of deregulation have not been considered as forms of State aid. Some of the possible reasons of such conclusion have been hinted at. What is important to note here is that this does not really seem to depend on difficulties with respect to their imputability to the State which seems to be clear, especially in the light of the flexible language of Article 87(1) EC.

The most significant findings of the case law concerning the issue of governmental direction may now be briefly exposed. We will then proceed to an assessment.

## A brief review of the case-law

In the recent *Stardust Marine* case, Advocate General Jacobs has analysed the case law on the issue of imputability and noted the variety of rules thereunder. We may indeed closely follow the clear exposition by the Advocate General. [167]

There have been some cases where the 'Court established in concreto that the particular measure at issue had been the result of action of the State'. In *Commission* v *France* (Poor farmers) [168] the Court thus held that a solidarity grant to farmers was covered by Article 87(1) because it was 'decided and financed by a public body' (the Caisse National du Crédit Agricole), its implementation was 'subject to the approval of the public authorities', the detailed rules for its grant corresponded to 'those for ordinary aid' and it was 'put forward by the Government as forming part of a body of measures in favour of farmers which were all notified to the Commission' under Article 88(3) EC.

In other cases, the concrete involvement of the government 'has been inferred from the circumstances taken as a whole'. The *Van der Kooy* [169] case concerned a preferential tariff for natural gas applied by Gasunie with respect to glasshouse growers. The Court found, first, that the State directly or indirectly held 50% of the

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purchase 30% of their supplies from companies established in the Mezzogiorno was by definition imputable to the State.

[167] Case C-482/99 *Stardust Marine*, paragraphs 58 to 62 of the Opinion.

[168] Case 290/83 *Commission* v *France* paragraph 15.

[169] Joined Cases 67, 68 and 70/85 *Van der Kooy and others* v *Commission*. Cf also Case C-56/93 *Belgium* v *Commission*, paragraph 10.

shares of Gasunie and appointed half of its supervisory board (whose powers included that of determining tariffs). Secondly, the 'Netherlands Government was empowered to approve the tariffs applied by Gasunie and could thus block any tariff which did not suit it and, third, the Netherlands Government had on two occasions successfully exercised its influence over Gasunie in order to seek an amendments of its tariffs'. In conclusion, according to the Court, 'considered as a whole, these factors demonstrate that Gasunie in no way enjoys full autonomy in the fixing of gas tariffs but acts under the control and on the instructions of the public authorities. It is thus clear that Gasunie could not fix the tariff *without taking account of the requirements of the public authorities*'. [170]

In other cases, it seems that the Court has been content to find that the body at issue 'operated in general under the control of the government'. In *ENI-Lanerossi* and *IRI-Alfa Romeo*, the Court found that the members of the boards of directors and the management boards of the two Italian holdings ENI and IRI were appointed by decree and did not have full freedom of action since they had to take the directives of the CIPE, the ministerial committee for economic planning, into account. Thus the conclusion was that, 'taken as a whole' those factors showed that ENI on the one hand and IRI on the other operated, 'in essence', 'under the control' of the Italian State. [171]

Finally, in other cases, the Court seems to have mainly focused on the public or private nature of the body at issue without examining 'whether it took its decisions - in the actual case or even in general - under the decisive influence of the public authorities'. In the *Air France* case the Court of First Instance found that the measure, although formally granted by a limited company governed by private law, was in reality carried out at the decisive instigation of the majority shareholder of the company, a public body, the Caisse des Dépôts et Consignations. 'The Caisse was established by law, it was placed under the supervision and guarantee of the legislature, its tasks was the administration of public and private funds composed of compulsory deposits, it was governed by statutory and regulatory rules and its Director-General and directors were appointed by the President of the Republic and

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[170] *Van der Kooy*, paragraphs 36 to 38, emphasis added.

the French Government. Those factors were sufficient for it to be held that the Caisse belonged "to the public sector" and the Commission was accordingly entitled to treat the Caisse as "a public-sector body whose conduct is attributable to the French State". The public nature of the Caisse was not called into question by the existence of rules which ensured that the Caisse enjoyed legal autonomy.' According to the Court, those rules did 'not call into question the principle itself of the public nature of that body'. [172]

The exposition of these cases shows that the assessment of the government involvement may operate at a *more concrete* or *abstract* level, and may be *more* or *less sophisticated.* Advocate General Jacobs put forward a convincing explanation of the variety of these rules – and of the seeming tension between these cases. The intensity of the standard, and hence of the Court's review, would 'depend on how far the public authorities are likely to be involved'. [173]

## The doctrine of the *Stardust Marine* case

In the *Stardust Marine* case the Court for the first time attempted to elaborate the rule of imputability under Article 87(1) EC. [174]

In so doing it heavily relied on the suggestions in the Opinion of Advocate General Jacobs. [175] He had significantly begun by noting that 'it is not easy to establish a general test to determine whether a given measure of a public undertaking is attributable or imputable to the State'. The same consideration would certainly be true also for the conduct of private undertakings. He then underlined that mere control over a body should not be sufficient inasmuch as 'the fact that the public authorities may exercise directly or indirectly a dominant influence does not prove that they actually exercised that influence in a given case'. At the same time, to avoid risks of circumvention, it should not be required that the involvement of the State be represented by an explicit instruction. In his view, it should 'be sufficient

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[171] See Case C-303/88 *Italy* v *Commission* ('ENI-Lanerossi'), paragraph 12; Case C-305/99 *Italy* v *Commission* ('IRI-Alfa Romeo'), paragraph 14.
[172] Case T-358/94 *Air France* v *Commission*, paragraphs 57 to 62.
[173] Case C-482/99 *Stardust Marine*, paragraphs 62 and 63 of the Opinion.
[174] Case C-482/99 *Stardust Marine*, paragraph 50 et seq.
[175] Ibid, paragraphs 64 to 68 of the Opinion.

to establish on the basis of an analysis of the facts and circumstances of the case that the undertaking in question could not take the decision in question "without taking account of the requirements of the public authorities"'. [176]

On the one hand, the Court upheld that a measure should not be imputed to the State merely because it is taken by a public undertaking. Being in the position to control a public undertaking does not mean actually exercising it in a particular case because 'a public undertaking may act with more or less independence, according to the degree of autonomy left to it by the State'. What –intriguingly - has to be examined is 'whether the public authorities must be regarded as having been involved, *in one way or another*, in the adoption of those measures' (emphasis added).

On the other hand, the Court denied that it is necessary to demonstrate that the public authorities have specifically incited the public undertaking to take the aid measure in question. Having regard to the close and privileged relations between the State and public undertakings, that would provide an incentive to grant aid in a non-transparent way. It would also make it difficult for a third party to demonstrate in a particular case that aid measures were in fact adopted on the instructions of the public authorities.

Having taking out the two most extreme standards (mere control – express instruction), the Court followed the rather flexible approach suggested by Advocate General Jacobs, concluding that

> the imputability to the State of an aid measure taken by a public undertaking may be inferred from a *set of indicators* arising from the *circumstances of the case* and the *context* in which that measure was taken. [177]

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[176] As examples of the facts and circumstances which could be taken into account he listed the evidence that the measure was taken at the instigation of the State; the scale and nature of the measure; the degree of control which the State enjoys over the public undertaking in question; and a general practice of using the undertaking in question for ends other than commercial ones or of influencing its decisions. Again to cope with any danger of circumvention, he indicated that, in his view, a generous approach should be taken with regard to proof possibly including also circumstantial evidence. Cf paragraphs 65 to 68 of the Opinion.
[177] Paragraph 55, emphasis added.

In line with the previous case law, a significant consideration was the fact that the decision to grant aid could not be made *without taking the requirements or directives of public authorities into account.* It then underlined that, 'in certain circumstances', other indicators 'might' be relevant 'in concluding that an aid measure taken by a public undertaking is imputable to the State, such as, in particular, 'its integration into the structures of the public administration, the nature of its activities and the exercise of the latter on the market in normal conditions of competition with private operators, the legal status of the undertaking (in the sense of its being subject to public law or ordinary company law), the intensity of the supervision exercised by the public authorities over the management of the undertaking, or any other indicator showing, in the particular case, an involvement by the public authorities in the adoption of a measure or the unlikelihood of their not being involved, having regard also to the compass of the measure, its content or the conditions which it contains'.

It may finally be interesting to note that, applying the findings above to the instant case, the Court concluded for the incorrectness of the adoption of the sole *organic* criterion, whereby the various measures of financing would have been imputable to the French State because Crédit Lyonnais and its two subsidiaries, as public undertakings, were under the control of the State.

### The *Pearle* case: the double-role of the concept of control in a boundary-case

We may now digress a bit by focussing on a recent and interesting case which can be viewed as a boundary-case.

A public body (notably a trade association) imposed on its members a compulsory earmarked levy to finance a collective advertising campaign for opticians' businesses. This levy was introduced on the initiative of a group of opticians belonging to the trade association, and, as said, was in the interest of all its members. The collective advertising campaign was eventually financed with the revenue collected from the earmarked levies.

Contrary to the usual situation, what emerges even from these brief factual elements is that it is the public body here that is used as *vehicle* of private action.

Although the reasoning of the Court is brief and not fully clear in distinguishing between the determination of imputability and the definition of the origin of financing, [178] it seems that the fact that the measure was taken at the initiative of a private association of opticians (and – we may add - was indeed in the interest of all members of the public body) was considered as sufficient to exclude its imputability to the public body. [179]

We might even suggest that, maybe also as a consequence of its not fully accurate drafting, what is interesting in *Pearle* is the revelation of the tight link between the two separate questions of imputability and financing. The connecting element is given by the concept of *control* which, as has already been shown in *Stardust*, plays a crucial role in both issues. [180] On the one side, to determine imputability we consider the *public control* over the acting third party. On the other side, as we will see, the qualification of resources as State resources requires the establishment of *public control* over them.

Although the Court could have drafted its findings in a better way, the *Pearle* decision does not depart from the previous case-law, and in particular from the doctrine elaborated in *Stardust*. [181]

## Analysis of the rules of imputability under Article 87(1) EC

This section analyses the findings of the case law of the Court, and in particular the test developed in the *Stardust* case which represents the first attempt to elaborate the rule of imputability under Article 87(1) EC.

### *The* Stardust's *rationalization: towards a flexible and case-by-case rule*

We have seen, and concurred with, Advocate General Jacobs' explanation of the variety of standards applied by the Court in the case law preceding *Stardust*, which

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[178] Vestendorf (2005) page 399 even suggest that the Court conflated the separate questions of control of resources and imputability.
[179] Cf Gambaro, Nucara & Prete (2005) page 5.
[180] Cf Hancher (2003) pages 748 and 749.
[181] Hancher (2004) page 363.

was based on the *likeliness* or *intensity* of the *involvement* of public authorities in the conduct of the third party.

What we substantially see in *Stardust* is a *rationalisation* of the previous case-law which takes the shape of a defined rule of imputability. Nevertheless, and inevitably (if both the variety of real situations and the looseness of the wording of Article 87(1) EC are considered), it may be appreciated that, far from being distinguished by precision, the test developed by the Court is rather characterised by a *flexible* approach. [182] After taking out the two extremes (a mere situation of control is not enough; an express instruction is not necessary), what the Court requires is a *case-by-case analysis.* The imputability may be inferred from a set of indicators arising from the circumstances of the case and the context surrounding the measure.

As suggested by Jacobs, a crucial factor for establishing imputability is obviously the impact of the direction exercised by the government on the third party (which the Court finds in the requirements and directives of public authorities).

In this regard, we should recall the Court's strict stand towards public control with respect to the issue of imputability. There is indeed a shift from a *formalistic* to a *functional* test. [183] The Court excluded that a mere situation of control on the public undertaking is enough to attribute all its activity to the State. What is required is an assessment of the *actual* exercise of such control in the case at hand.

This might seem to be partly contradicted by the reference, 'in certain circumstances', to other indicators that 'might' be relevant and that often seem to involve a rather *abstract* link with the public power (see, for instance, the integration of the public undertaking into the public administration, its legal status, or the intensity of the supervision exercised by public authorities) and thus to simply correspond to the fact that the undertaking in question is under public control. [184]

In the writer's view, there is no contradiction in the findings of the Court if it is accepted that they constitute a rationalisation of the indications of the previous case-law. The key-words are flexibility and case-by-case analysis. Whereas what is usually required is an assessment of the actual exercise of direction, in other cases,

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[182] Alexis (2002) page 152.
[183] Hancher (2003) page 749.

considering that the government involvement is quite likely, more abstract or organic elements are sufficient to establish the imputability.

### *Regulatory measures and imputability: beyond* Stardust

What is now interesting to ask is whether the rule of imputability under Article 87(1) EC as defined in the *Stardust* case could cover some of those measures that we have defined as regulatory which always involve the role of an intermediary.

We may commence with the measures of deregulation. The peculiarity of this course of conduct is that the State's direction is clearly addressed to the beneficiary undertakings, which are immediately exempted from rules or restrictions, with the intermediary, which effectively finances the operation, playing a passive role. Clearly, the test as developed in *Stardust*, which focuses on acts of direction immediately addressed to the intermediary, does not apply here. Nevertheless, to negate that the measures at issue are imputable to the State would be absurd. Since the State's conduct *directly* affects the beneficiary undertakings by exempting them from rules and restrictions, the former's involvement is rather apparent, better self-evident. As anticipated, if these measures are not considered as State aid, this should be explained for other reasons, concerning their financing and/or their objectives.

The next question is whether more complex cases where the government may be viewed as directing a third party to carry out a measure of support but certainly does not do so in an immediate and direct way, such as where the benefit is conferred through border measures (whose legal status under GATT/WTO law it has been extensively analysed above), could be covered by the rule of imputability crafted by the Court in *Stardust*.

It does not seem that the Court had these cases in mind when it laid down the rule in *Stardust*. There has been no previous case-law on the point. Despite its inherent flexibility, the *Stardust* test seems to refer to more traditional cases, where, if present, the involvement of the government is particularly direct.

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[184] See Lübbig & Von Merveldt (2003) page 623.

The issue however remains open. Generally speaking, although less immediate, the involvement of the government can certainly be established in some cases.

Especially in certain circumstances, when the causal nexus between the border measure and the third party's conduct is particularly proximate, the imputability to the State may be particularly clear (cf the US argument in *US – Export Restraints*). Most crucially, from a more legal perspective, Article 87(1) EC does not face the strictures of a well-defined test (such as that of Article 1.1(a)(1)(iv) SCM) or, more generally, of a rigid textual approach (such as in the WTO). It has already been seen in the first chapter, and the point will be developed in the final section of this chapter, that the approach to interpretation is quite liberal in EC law since it is heavily influenced by teleological considerations.

Arguments against the coverage of these measures under Article 87(1) EC would be similar to those deployed with respect to measures of deregulation, and might thus revolve around the source of financing or the objectives of the measures.

***Conclusions on the rules of imputability under Article 87(1) EC***

Various arguments, based on the loose wording of Article 87(1) EC and on the liberal approach to interpretation in EC law, seem to support the adoption with respect to more complex courses of action, such as some forms of regulatory measures, of a rule of imputability more extensive than that laid down in the *Stardust* case. A confirmation thereof is that the objections to the coverage of these more complex measures have not focused on imputability but on other levels (financing and objectives). Arguably, some support to our broad reading might even be found in the ethos of *Stardust* itself and, in particular, in the two defining concepts of its rule of imputability: *flexibility* and *case-by-case analysis*.

## Origin of resources

In the EC, a controversy similar to that on the 'cost to the government', has come out from the interpretation of the - rather ambiguous - expression 'granted by the State or through state resources' in Article 87(1) EC.

The current official position, as stated in *PreussenElektra*, is that the definition of State aid necessarily implies the use of State resources. It is however argued that the stability of this conclusion is somewhat weakened by other, more or less concomitant, hesitant and contradictory statements.

Before the State resources requirement is analysed, it may be interesting to examine the jurisprudence of the Court on the issue.

## The case-law on the need of a transfer of State resources

It may be useful to divide the exposition of the case-law in two parts, the first concerning the initial period, where the case law of the Court was not settled yet, and the second focusing on the second period, where the Court consolidated its jurisprudence whereby financing through State resources is necessary.

It may also be useful to recall that in the reasoning of the Court the *financing* argument is often blended with other considerations which seem to be based on the regulatory nature or on the objective of the measure. Although this ambivalence emerges from the following exposition, the reader is invited to concentrate on the point concerning the *origin of the resources* which will then be subject to analysis. A final note on style. For the reader's convenience, the writer opted for extensive quotations of the significant findings of the Court.

### *The first period: fluctuations*

In the first period the Court was still fluctuating. We therefore find decisions containing contradictory statements.

The *Van Tiggele* case concerned a measure fixing a minimum price for gin. [185] One of the issues was whether, apart from constituting a measure having an effect equivalent to a quantitative restriction on imports under Article 28 EC, 'price-control rules' could amount to a state aid under Article 87(1) EC. The Court followed the Opinion of Advocate General Capotorti [186] and concluded that:

> [w]hatever definition must be placed on the concept of an 'aid' within the meaning of [Article 87] it is clear from the wording thereof that a measure characterized by the fixing of minimum retail prices with the objective of favouring distributors of a product at the exclusive expense of consumers cannot constitute an aid within the meaning of Article [87]. [187]

Probably, as a sign that this finding in itself was not self-sufficient, the Court went on to underline immediately that:

> The advantages which such an intervention in the formation of prices entails for the distributors of the product are not granted, directly or indirectly, through State resources within the meaning of Article [87]. [188]

The issue was subsequently raised before the Court in the *Norddeutsches Vieh- und Fleischkontor* case which concerned the allocation of special tariff quotas for the importation of frozen beef and veal from non-member countries. [189] Three traders challenged German legislation that determined the allocation of national quota share between domestic traders also on the ground that it constituted State aid in favour of certain other traders. Advocate General VerLoren van Themaat opined that it was possible to argue, on the basis of the distinction made in Article 87(1) between 'aid granted by a State' and 'aid granted through state resources', that the independent grant of pecuniary advantages which were not paid for by a Member State were caught by Article 87 EC. He mentioned, as an example, the case of

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[185] Case 82/77.
[186] See paragraph 8 of the Opinion.
[187] Paragraph 24.
[188] Paragraph 25.
[189] Joined Cases 213 and 215/81.

reduced rates which Member States might require private electricity companies or haulage contractors to grant to certain undertakings or in respect of certain products. [190]

The Court disagreed and found that:

> the financial advantage which traders derive from receiving a share in the quota is not granted through State resources but through Community resources because the levy which is waived is part of Community resources. Although the term 'aid granted through State resources' is wider than the term 'State aid', the first term still presupposes that the resources from which the aid is granted come from the Member State. [191]

In *Commission* v *France (Poor Farmers)* what was at issue was a solidarity grant to poor farmers which was financed by the operating surplus of the French *Caisse national de crédit agricole.* [192] As we have seen in the previous section, there was no doubt that the decision to grant the aid could be imputed to the State. The Commission considered that the resources used to finance the measure were generated from the management of private funds and not State resources. It nonetheless claimed that, although the measure under scrutiny was not, strictly speaking, a State aid, it should have been prohibited by Article 10 EC, being a measure having an effect equivalent to a State aid.

On a different construction of the facts, Advocate General Mancini concluded that the use of State resources was indeed involved. [193] The Court did not examine whether the grant was financed by State resources. It however noted that

> [b]y the generality of the terms employed in that provision any State measure, in so far as it has the effect of according aid in any form whatsoever, may be assessed on the basis of Article [87] for its compatibility with the common market.

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[190] Ibid, page 3617.
[191] Paragraph 22.
[192] Case 290/83.
[193] It is useful to recall the quite firm stance of the same Advocate General in the *Fediol* cases (Cases 187/85 and 188/85) where he underlined that, 'although unsupported by rules of Community or international law', it is 'semantically and logically indisputable' that the requirement of cost to government is inherent in both the notions of GATT subsidy and EC State aid (see pages 4177 and 4178).

> As is clear from the actual wording of Article [87(1)], aid need not necessarily be financed from State resources to be classified as State aid. [194]

The persisting fluctuations of the Court can be appreciated in two cases decided shortly afterwards, *Van der Kooy* (where the point is not clearly touched) [195] and *Greece* v *Commission* (which fully upholds *Commission* v *France*). [196]

***The second period: towards stability?***

The *Sloman Neptun* decision represents a robust *revirement* towards a restrictive approach with respect to the 'State resource' issue which, after more than ten years, is now firmly consolidated. [197]

The national legislation under examination enabled certain shipping undertakings flying the German flag to subject seafarers who were nationals of non-member countries to working conditions and rates of pay less favourable than those applicable to German workers. Albeit not fully clear, the reasoning of the Court heavily relies on the fact that the legislation at issue would not allegedly involve a transfer of State resources.

It can also be recalled that neither the Commission nor Advocate General Darmon concluded that a transfer of State resources is necessary under Article 87(1) EC. Contrary to its position with respect to the notion of subsidy under GATT law, [198] the Commission was arguing that a measure of whatever nature which entails for a particular sector a relief which is not part of a comprehensive system is State aid even if it is not financed from public funds. This conclusion derived from both the wording of Article 87(1), and in particular the distinction between aid granted by a State and aid granted through State resources, and from the purpose of State aid rules to protect competition. In any event, the loss of tax revenue resulting from

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[194] Paragraphs 13 and 14.

[195] Joined Cases 67/85, 68/85 and 70/85. Although the emphasis of the analysis of the Court seems to be on the issue of imputability, there is indeed a brief reference to the lower profit that the State would have received from the application of a lower tariff (see paragraph 28). What is not clear, however, is whether this reference should be viewed as a recognition that a financial burden is a necessary requirement of the notion of State aid or, more simply, of a conferral of an out-of-the-market advantage.

[196] Respectively and Case 57/86, paragraph 12.

[197] See Joined Cases C-72/91 and C-73/91.

the level at which rates or pay were fixed supported the view that the measure at issue was financed from State resources. On its part, Advocate General Darmon argued that the origin of the financing of an aid measure was not relevant. In his view, Article 87(1) only required that the aid measure was the result of conduct for which a Member State was responsible (and conferred an advantage on certain undertakings by derogating from the relevant system).

The Court rejected these arguments and, referring to its decision in *Van Tiggele*, held that

> only advantages granted directly or indirectly through State resources are to be regarded as State aid within the meaning of Article [87(1) EC]. The wording of this provision itself and the procedural rules laid down in Article [88 EC] show that advantages granted from resources other than those of the State do not fall within the scope of the provisions in question. [199]

In the light of this finding, (and with a reminiscence of one *dictum* in *Steinicke und Weinlig*) [200] the Court then underlined the anti-circumvention purpose of the distinction set forth in Article 87(1) EC:

> [t]he distinction between aid granted by the State and aid granted through State resources serves to bring within the definition of aid not only aid granted directly by the State, but also aid granted by public or private bodies designated or established by the State. [201]

Turning then to the issue of whether the advantages deriving from the measure at issue were to be viewed as being granted through state resources, the Court held:

> [t]he system at issue does not seek, through its object and general structure, to create an advantage which would constitute an additional burden for the State or the abovementioned bodies, but only to alter in favour of shipping undertakings

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[198] See Cases 187/85 and 188/85 *Fediol*

[199] Paragraph 19.

[200] Case 78/76 *Steinincke und Weinlig*, paragraph 21.

[201] Paragraph 19.

> the framework within which contractual relations are formed between those undertakings and their employees. The consequences arising from this, in so far as they relate to the difference in the basis for the calculation of social security contributions, mentioned by the national court, and to the potential loss of tax revenue because of the low rates of pay, referred to by the Commission, are inherent in the system and are not a means of granting a particular advantage to the undertakings concerned. [202]

The principle of *Sloman Neptun* was upheld in the following *Kirsammer-Hack* and *Viscido* cases. In the first case the Court concluded that the exclusion of small businesses from a legal regime requiring payment of compensation in the event of unfair dismissals of employees (and at the same time exempting the latter from bearing the legal costs incurred in the relevant legal proceedings) did not constitute a grant of aid. [203] Following the line of *Sloman Neptun*, the Court found that

> the exclusion of a category of businesses from the protection system in question does not entail any direct or indirect transfer of State resources to those businesses but derives solely from the legislature's intention to provide a specific legislative framework for working relationships between employers and employees in small businesses and to avoid imposing on those businesses financial constraints which might hinder their development. It follows that a measure such as the one in question in the main proceedings does not constitute a means of granting directly or indirectly an advantage through State resources. [204]

A similar conclusion was reached in *Viscido* where the measure at issue allowed only one undertaking, Ente Poste Italiane, to derogate from the general rule under Italian law that employment contracts should be of indeterminate duration, and permitted the recruitment of staff under fixed-term contracts. [205] Contrary to the two previous cases, the Court did not refer to the regulatory nature or the objective of the legislation but merely concluded that the measure at issue 'does not involve any direct or indirect transfer of State resources' to the benefited undertaking. [206]

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[202] Paragraph 21.
[203] Case C-189/91 *Kirsammer-Hack*.
[204] Paragraphs 17 and 18.
[205] Joined Cases C-52/97, C-53/97 and C-54/97 *Viscido*.
[206] Paragraph 15.

The principle that the notion of State aid under Article 87(1) necessarily requires a transfer of State resources has been followed also in the *Ecotrade* and *Piaggio* decisions. [207] The examination of these decisions leads us to two brief remarks. On the one side, we cannot but note the language used by the Court in its reasoning which alternatively refers to the concept of 'State resources' and, with a reminiscence of *Sloman Neptun* (see paragraph 21 therein), to the notion of 'additional charge for the State'. Frankly, no explanation for this linguistic variation, nor any argument affecting the substance of the debate, can be found. On the other side, it is more intriguing to highlight the inconsistency between the reasoning, which unequivocally requires a burden for the State, on the one hand, and the conclusions of that reasoning (see *Ecotrade*, paragraph 45, and *Piaggio*, paragraph 43) and the corresponding operative parts of both decisions where the use of State resource is merely formulated as an *alternative* requirement, on the other. What is interesting to ask is whether this can quite simply be explained with poor drafting or is more tellingly ascribable to a sort of Freudian slip...

In the last vigorous attack to the 'State resources' doctrine, in the *PreussenElektra* case, the Court followed the well-reasoned Opinion of Advocate General Jacobs and reaffirmed its position. [208] The Court concluded that national legislation requiring private electricity supply undertakings to purchase electricity produced in their area of supply from renewable energy sources at minimum prices higher than the real economic value of that type of electricity did not constitute state aid within the meaning of Article 87(1) because there was no direct or indirect use of State resources. Indeed the financial burden resulting from that purchase obligation was distributed by the legislation between those electricity supply undertakings and upstream private electricity network operators. [209]

It is, however, the latest (at least to our knowledge) word of the Court on the issue which leaves some perplexities about the solidity of this jurisprudence and, in particular, about the *real* rationale underlying the Court's position.

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[207] Respectively, Case C-200/97, paragraph 35; Case C-295/97, paragraph 35.
[208] Case C0379/98.
[209] Paragraphs. 58-60.

In the *Cigliola* case, [210] the Court was asked by the Tribunale di Genova whether Italian legislation which 'allows an undertaking, Ferrovie dello Stato, to dismiss its older employees - thereby creating a situation in which the undertaking can save on labour costs (salaries and insurance obligations), with an immediate resulting burden to the State in the form of reduced contribution revenue and the payment of pensions to dismissed workers - fall within the concept of aid that is incompatible with the common market within the meaning of Article 87 of the Treaty'. [211]

Considering that the answer to the question referred by the national Court could be clearly deduced from the existing case law, the Court disposed of the case on 14th April 2004 by way of order. [212] Even from a brief reading of the question referred, it however emerges that the factual and legal background was not really the same as that in the previous case-law and that the issue as to whether, in this case, State resources had been used or not would have requested a more thorough analysis, probably with an Opinion of the Advocate General, a hearing, and, ultimately, a judgment.

The reasoning of the order refers to the previous case-law, particularly to *Sloman Neptun*. [213] It nonetheless seems that at least two circumstances distinguished this case from *Sloman Neptun*. First, the national measure allowed the *dismissal* of employees, thus clearly impacting on ongoing relationships, and, most importantly, on labour costs *currently* borne by the undertaking at issue. This is why the national court probably highlighted the *immediacy* of the burden for the State finances. The financial impact of the measure could indeed be increased by the second distinguishing factor, that is the fact that, as a consequence of the said dismissal, the State was obliged to pay the dismissed workers' pensions immediately. Oddly, this element is not dealt with at all by the Court.

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[210] Case C-59/03 *Cigliola* v *Ferrovie dello Stato*.
[211] See OJ 2003 C83/12, 5 April 2003.
[212] The relevant legal basis is Article 104(3) of the Rules of Procedure which allows the Court to decide a case with reasoned order (and without Advocate General's Opinion) 'where a question referred to the Court for a preliminary ruling is identical to a question on which the Court has already ruled, where the answer to such a question may be clearly deduced from existing case-law or where the answer to the question admits of no reasonable doubt'. A notice with a provisional translation of the operative part of the order has been published in OJ 2004 C106/17.
[213] A copy of the order in the language of the case (Italian) has been obtained from the Registry of the Court on 7th November 2005.

Admittedly, doubts could be entertained about whether the *overall* impact of the measure was really to involve a use of State resources. As in *Viscido* the measure at issue was intended to give flexibility to the beneficiary undertaking and thus the actual assessment of any *net burden* for the State might be difficult to ascertain. [214]

The Court, however, was quite sure about which position to take, and this is rather apparent from the language of its conclusion which follows almost word for word the (controversial) question referred. Considering its significance, it deserves a full quotation:

> [a] national law which allows an undertaking to terminate the contracts of employment of its oldest workers, setting aside ordinary law that permits continuation of the employment relationship and which thereby creates a situation in which the undertaking can save on labour costs, with *an immediate resulting burden on the State in the form of reduced contribution revenue and the payment of pensions to dismissed workers*, does not constitute State aid within the meaning of Article 87(1) EC. [215]

To our eyes the contradiction is clear. The Court expressly recognises that the measure produces 'an immediate resulting burden on the State in the form of reduced contribution revenue and the payment of pensions to dismissed workers'. This, however, does not amount in its view to a use of State resources.

It is time for the final, important questions. Can we really say that, after the fluctuations of the first period, the Court has eventually achieved *stability*? Are these cases *really* decided on the basis of the *technical* argument of the 'State resources' requirement? Or, rather, the *real* rationale must be found somewhere else?

## Analysis of the 'State resources' requirement

The determination of whether the notion of State aid necessarily requires a use of State resources has always been subject to a heated debate. The phrase 'granted by

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[214] See, in this regard, the penetrating observation of Advocate General Jacobs in Joined Cases C-52/97 and C-54/97 *Viscido*, paragraph 15 of the Opinion, with respect to the uncertainty and non-quantifiability of the cost to the government in such circumstances.

[215] See paragraph 25 and the operative part (emphasis added).

the State or through State resources' in Article 87(1) EC has usually been subject to two contrasting interpretations.

### *Extensive interpretation*

According to the first, more extensive approach, [216] only the second part of that phrase would refer to a financial burden for the State. The first part, quite generally referring to 'any aid granted by the State', would include all remaining measures which, although attributable to the State, are not financed by it. This interpretation is consistent with the broad wording of Article 87(1) EC, which prohibits 'any aid in any form whatsoever', and, in particular, with the focus on the *effects* of the measures which is usually derived therefrom. [217] Indeed the most important argument in support of this position is the *teleological* one. If, according to Article 3(g) EC, the main purpose of State aid rules is to safeguard the functioning of competition from distortions created by public intervention in favour of certain undertakings and production, the source of the financing of that measure is not material.

The (too) formalistic interpretation of Article 87(1) EC, whereby only advantages financed through State resources would be considered as State aid, would eventually create an *incentive* on Member States to *circumvent* State aid regulation. The clearest example would occur when the State, rather than granting aid through a fund financed by private contributions, decided to mandate on private individuals or undertakings to make payments directly (ie without the intermediary of any fund) to given undertakings. The State would achieve its aim without suffering any cost. The potential distorting effect of the two measures would not be different. This point has been clarified by Advocate General Darmon in *Sloman Neptun*:

> [l]et us take, for the sake of argument, a public measure which requires individuals - consumers, workers, trading companies or any other category of private persons - to pay certain sums to a given undertaking or a given sector of the industry. In my view, it follows from the *ratio legis* of Article [87], namely

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[216] Cf Slotboom (1999); Ross (1995); Bacon (1997); Roberti (1997); Conte (1999); Ross (2000). On the widespread criticism of the recent *PreussenElektra* decision see, among others, Broncker & Van der Vlies (2001). Baquero Cruz & Castillo de la Torre (2001); Goossens & Emmerechts (2001); Rubini (2001).
[217] See Case 173/73 *Italy* v *Commission*, paragraph 13; Case 78/76 *Steinicke und Weinlig*, paragraph 21.

> maintaining *equal conditions of competition* between rival traders, that such a measure ought to be classified as aid. The 'public' nature of the aid which is implicit in Article [87(1)] relates more to the authority which adopted the measure - the State and its agencies - thereby disrupting normal market conditions, than to the body or person financing the aid. [218]

***Restrictive interpretation***

The other approach, which, as we have seen, is supported by the consistent case law of the Court, [219] construes the notion of State aid in a more restrictive fashion. [220] The principle is that only advantages granted directly or indirectly through State resources can be considered as state aid. The reference in Article 87(1) to aid 'granted through State resources' would only mean that that provision covers not only State aid granted directly by the State but also that granted through other public or private entities.

In his Opinion in the *PreussenElektra* case Advocate General Jacobs put forward various arguments in support of this more restrictive position whereby the use of State resources is a constituent element of the notion of State aid. In particular, he observed that this is so because it 'provides more legal certainty'. In his view,

> the more extensive interpretation would oblige the Member States, affected undertakings, the Commission, national courts and ultimately the Community Courts to decide in respect of all legislation regulating the relationship between enterprises whether it does confer selective advantages on certain undertakings within the meaning of Article [87(1)]. Since such an assessment is a difficult exercise with an uncertain outcome, it seems preferable that legislation regulating the relationship between private actors is as a matter of principle excluded from the scope of the State aid rules. [221]

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[218] Paragraph 40 of the Opinion. An additional argument is that the restrictive interpretation is likely to prejudice the power of control of the Commission under Article 88 EC. In the *PreussenElektra* case, the Commission itself underlined the importance for State aid control of such procedure, particularly in the light of the recent developments in the EU (the completion of the internal market and the introduction of the EMU). In this regard, 'selectively applied aid measures are the last remaining instrument which the Member States can use to confer competitive advantages on domestic undertakings' (cf paragraph. 146 of the Opinion of Advocate General Jacobs).

[219] After *PreussenElektra*, more recent confirmations can be found in Case C-482/99 *Stardust*, and Case C-245/02, *Pearle*.

[220] Cf, for example, Plender (2004); Biondi & Eeckhout (2004).

[221] Opinion in *PreussenElektra*, paragraph 157.

This argument is similar to the *pragmatic* argument advanced in the Opinion in *Viscido.* After observing that the measures at issue did not involve a use of state resources, Jacobs rejected that state aid rules could cover 'all labour and other social measures' that are selective and might distort competition because 'to investigate all such regimes would entail an inquiry on the basis of the Treaty alone into the entire social and economic life of a Member State'. [222]

In *PreussenElektra* he further observed that the danger that Member States resort to large scale support for certain domestic undertakings which is financed through private resources, have the same anticompetitive effects as State aid and escape the Commission's control, in a single phrase the 'risk of circumvention', should not be exaggerated. Other provisions of the domestic and Community order are indeed likely to apply to those measures. [223]

### *Method of financing and legal certainty*

Leaving aside for the moment the issue of the applicability of other rules (which can be summed up in the question of regulation of policy substitution), we will spend some time on the important argument concerning *legal certainty.* In particular, what we want to test is whether the 'State resources' requirement provides for the legal certainty that we would lack in its absence.

Before focussing on this important point, the writer would like to make some general remarks on the role of the *method of financing* a measure of financial support.

It can be easily agreed that a subsidy to a given industry or undertaking will in general alter the level playing field irrespective of whether it is financed with public or private money (it is sometimes wittily underlined that the State resources are financed with taxes and hence, in the last analysis, with resources coming from private individuals and undertakings).

This does not detract from the fact that the method of financing of the measure may indeed produce a different impact, and is thus a factor that the Commission has

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[222] Opinion in *Viscido*, paragraph 16.
[223] Opinion in *PreussenElektra*, paragraph. 158.

to take into due account when examining a plan to grant State aid under Article 88 EC. [224]

On a general note, it may be underlined that the allocation of the financial *burden* of the State aid measure may aggravate the distorting effect of the *advantage* conferred by it. That would occur, for example, if an aid to certain undertakings were financed by its competitors. [225]

With more specific regard to the 'State resources' issue, the fact itself that the State grants aid, and, most importantly, provides the resources to finance it, may certainly raise particularly concerns because of the virtually unlimited government resources (or, in any event, potentially greater if compared with private ones). Thus *predatory* conduct backed by the hugely 'deep pocket' of public actors has definitely more chances to succeed as, by definition, there is no need to 'recoup' when competitors have been drawn from the market. [226]

That said, to require, in general terms, the use of State resources as a necessary element of the notion of State aid is not justifiable from the point of view of the stated objective of State aid rules, the safeguard of competition. For this reason, it is submitted that the reading that seems to be more in line with the *purpose* of State aid rules is the more extensive one, ie Article 87(1) EC does not require that a State aid be necessarily financed through State resources. Truly, although *in some cases*, public financing may have a bigger potential to disrupt competition and trade, it can *in general* be predicated that the nature of the resources used to finance a State aid is not crucial from this point of view. To put it in another perspective, it seems that the method of financing the measure is not very significant to define the *boundaries* of the definition of State aid but rather in order to assess its *effects*.

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[224] Cf Case 47/69 *France* v *Commission*, paragraph 14, where the Court even suggested that the method of financing the aid could not be isolated from the 'aid as such' so that the former, in conjunction with the 'aid in its narrow sense', could render the 'whole' incompatible with the common market (paragraph 4).
[225] This is exactly what happened in *PreussenElektra*. Cf also the remark of Advocate General Jacobs in Joined Cases C-261/01 and C-262/01 *Van Calster*, paragraph 40 of the Opinion, where he suggested that the recovery of charges financing an illegal aid scheme is particularly important 'if they themselves create distortions of competition and trade which would add to and reinforce the distortion produced by the aid itself. That may occur if they are imposed on competitors of the beneficiaries of the aid or if the charges are such as to produce a protective effect and five some form of advantage to the domestic market'.
[226] Predation is a common – and controversial - topic in competition law. For a general treatment in EC and US antitrust law, and for further references, see Whish (2003: 703-710); Jones & Sufrin (2004: 385-403). Predation is also an important topic in subsidy law (and anti-dumping law). See, for example, Jackson (1997: 283); Trebilcock & Howse (2005: 283).

We may now concentrate on the important argument, put forward by Advocate General Jacobs various times, concerning *legal certainty*. To briefly repeat the point: the 'State resources' requirement would constitute a useful tool of selection of measures since, in its absence, the State aid regime might be confronted with 'all legislation regulating the relationship between enterprises' and ultimately with 'the entire social and economic life of Member State'.

We start, as usual, from the analysis of the case-law which defines what 'State resources' are.

In *Ladbroke* the Court confirmed that the concept of State resources 'covers all the financial assistance by which the public sector may actually support undertakings, irrespective of whether or not those means are permanent assets of the public sector'. What, crucially, would ultimately matter is that these resources are 'under the control' of the State. [227] This principle was repeated in *Stardust* where the Court concluded that the resources of public undertakings, 'falling within the control of the State' and being therefore 'at its disposal', amount to State resources. [228] In explaining the previous case law on the point, Advocate General Jacobs noted that

> [t]he common denominator of the relevant cases is that the State exercised direct or indirect control over the resources in question despite the fact that the funds did not come from the State budget. In the case of parafiscal charges the funds were first brought under the State's control before they were redistributed to the undertakings concerned. In the case of a waiver of revenue the State renounced funds which it was legally entitled to claim. State resources are therefore those resources which are directly or indirectly under the control or in other words at the disposal of the State. [229]

As said, the position of the Advocate General was upheld by the Court which thus adopted a quite extensive notion of 'use of State resources' (it is interesting to note

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[227] Case C-83/50P *France* v *Ladbroke Racing and Commission*, paragraph 50. The same finding was previously made by the CFI in Case T-358/94 *Air France*, paragraphs 66 and 67.
[228] Case C-482/99 *Stardust*, paragraph. 38.
[229] Paragraph. 41 of the Opinion.

that the concept of 'public control' used to impute the conduct of the public undertaking to the State is stricter than that used to define State resources). [230]

Allegedly, this broad approach to the notion of State resources is *not formalistic*, and, to some extent, may be regarded as a counter-balance to the previous, *more formalistic*, finding in *PreussenElektra* where the unclear wording of the phrase 'granted by the State or through State resources' Article 87(1) EC was read as requiring a 'cost to government'.

Arguably, however, this broad notion of State resources does not provide a useful key of interpretation. The point is that the exact boundaries of the scope of 'public control' are difficult to define. In other words, the issue is: how far this crucial concept could be stretched? It could in fact be argued that it has the potential to include if not all, at least many, cases where the State is somewhat involved in the financing.

The comparison between measures that are commonly held to be State aid and measures that are not makes this difficulty evident.

Whereas it is clear that a measure funded through a tax borne by consumers would clearly be regarded as a State aid, it is not clear why support through a government-mandated minimum-price scheme, which is eventually financed by consumers, would not constitute a State aid (see *Van Tiggele*). Quite similarly, whereas, despite some doubts, [231] it is accepted that there is a use of State resources when the State empowers a private or public body to levy parafiscal charges on private undertakings, that is not the case when the State mandates private undertakings to make payments in favour of other undertakings (see *PreussenElektra*).

It can further be asked how it is possible to distinguish between the non-application of employment legislation with the result that labour costs of certain undertakings (including social contributions) are reduced, which does not amount to State aid (see *Sloman Neptun*), [232] and the introduction of special legislation, notably training and

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[230] While the Court finds that the resources of public undertakings are *always* under the control and at the disposal of the State and hence constitute state resources, what it requires to attribute the conduct of the public undertaking to the State is the *actual* exercise of its influence on the former.

[231] See Slotboom (2002: 522); Quigley (1988: 250).

[232] The Court's argument about the 'inherency in the system' of the loss of social contribution (which could also be seen as referring to the *remoteness* of the loss) is not very convincing. A similar conclusion can quite

experience contracts, providing for a reduction of social security contributions, which has been found to constitute State aid (see Case C-310/99 *Italy* v *Commission*).

Admittedly, there are no sound reasons to distinguish between the cases set forth above as it can reasonably be held that, in all of them, the resources used to finance the aid measure are, 'directly or indirectly', 'under the control' or 'at the disposal' of the State. On the basis of the current case-law, maybe through a progressive interpretation, they could all be regarded as involving a use of State resources.

From this perspective, the differential approach of the Court seems to be too much *formalistic* and not in line with the case law that underlines the purpose of State aid rules. On the one side, with its Byzantinism, it provides for Member States an easy way, if not an incentive, to circumvent the rules. At the same time, and most importantly, it is not fully satisfactory because, with its distinctions, it does not provide clear and consistent directives.

Two further examples can be given that show the blur of the 'control' criterion. 'Soft loans' are usually regarded as State aids. [233] In such a case, according to the key of interpretation of *Stardust*, despite its inherent impalpability, the revenue that is foregone in the cases of opportunity costs should be considered 'under the control' or 'at the disposal of' the lender. Another example is offered by the *Pearle* case where the issue of financing was not only intertwined with that of imputability, but, arguably, was in fact dependent on it. The important point (and element of instability) is thus that, in the last analysis, the resources were not held to be public because the measure was not *imputable* to the public body at issue.

In conclusion, there are good reasons to doubt about the conclusiveness of one of the most important arguments which are put forward in support of the 'State resources' requirement. The previous exposition has, in our view, shown that there are good reasons to conclude that, at least in some cases, rather than providing more *legal certainty*, the 'State resources' requirement does raise serious concerns thereon.

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probably be drawn also with respect to the potential loss of tax revenue deriving from the lower employees' wages (see also similar cases: C-200/97 *Ecotrade*, paragraph 36; C-379/98 *PreussenElektra*, paragraph 62).

***Conclusions: is the 'State resources' requirement the real issue?***

The previous analysis has shown that it should be asked whether the reference to a 'cost to government' is really an appropriate tool to define the *boundaries* of the notion of State aid.

It is however the assessment of the *Cigliola* decision that, in our view, fully sheds light on the ***real rationale*** of this strand of case law. What emerges is that the 'State resources' issue is just the - rather unjustifiable and imprecise - *technical* argument which the Court expressly relies on to dispose of cases that, in fact, it does not consider as State aid for other reasons.

In our view, this reason mainly (and, as we will argue, unjustifiably) relate to the *regulatory nature* and/or the *objective* of the measure at issue. [234]

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[233] For a definition of 'soft loan' see note 129 above.
[234] This true rationale was indeed caught by Davies (1995), an article significantly cited also by Advocate General Jacobs in his Opinion in *Viscido*.

## 3. The relevance of the objectives in subsidy and State aid rules

Government may intervene in the market for various reasons, to make up for market failures or to pursue other legitimate socio-economic aims. [235]

One of the techniques to define the legal relevance of a certain action of the government may be to refer to the public policy objectives that are pursued by the latter. In this section we put forward some brief considerations on the role played by the public objectives in the regulation of subsidies and State aids. Considering their general applicability we analyse both EC and WTO law together.

There is a specific reason why we deal with this technique at the end (after having examined the formulation of the definition, the rules of imputability and the origin of the resources).

On the one hand, it does not seem that the objectives pursued by the measure at issue have been particularly relevant in defining what conduct amounts to a subsidy or a State aid. On the other hand, the issue of the role played by the objectives of the measure is a recurring theme in the various stages of the analysis of the regulation of subsidy and State aid. This section is thus intended to represent a useful bridge to the analysis of the following chapters.

### Unrecognized objectives and rule-oriented systems

We should immediately underline that some objectives cannot be relevant *at all* in either legal system.

The most notable example is that of so-called *countervailing-subsidies*, that is of subsidies that are granted to counter the effects of similar practices of other Member States.

Apart from the more general considerations concerning subsidy-races and potential political and diplomatic tensions, the main legal argument against giving relevance to

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[235] It is known that quite often market do not function perfectly for various reasons and that their natural outcomes may not be acceptable to a given society for reasons of efficiency or equity. This kind of issues belongs to ***welfare economics*** (see note 55 above). See, *inter alia*, Begg, Fischer, Dornbush (1997: 240) et seq; Stiglitz (2000: *passim* and 53 et seq); Barr (2004: *passim* and Part 1). The issue of market failures is dealt with in the final chapter on the regulation of effects and objectives.

*countervailing-subsidies* is that they undermine any *rule-based system* founded on co-operation and on an agreed regime of control of subsidies. This was already clearly found by the GATT *DISC* Panel when it noted that

> [i]t could not accept that one distortion could be justified by the existence of another. [236]

A few years afterwards, the Court formulated a similar principle in the context of EC law observing that:

> [t]he effects of more than one distortion of competition on trade between Member States do not cancel one another out but accumulate and the damaging consequences to the common market are increased. [237]

From another perspective, countervailing subsidies or aids are a form of *self-defence.* It is known that this is in principle accepted only in exceptional and residual circumstances (with a Latin tag it is called *extrema ratio*). [238] However, in solidly rule-based systems such as the EC and the WTO they are not permitted altogether. [239] In the context of GATT/WTO (but not in the EC), what is *exceptionally* permitted (constituting an express derogation – but always a derogation - from Article II GATT) is only to apply, in certain circumstances and according to certain procedures, countervailing *duties.* [240]

An important affirmation of the importance of 'staying within the rules' comes from Article 32.1 SCM which provides that 'no specific action against a subsidy of another Member can be taken except in accordance with the provisions of GATT

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[236] Paragraph 79.
[237] Case 78/76 *Steinicke* v *Germany*, paragraph 24.
[238] See, more generally, Shaw (2003) page 1024 et seq.; Brownlie (2003) page 697 et seq.
[239] In the EC, this principle has been affirmed also with respect to the grant of aid by third countries which cannot justify the non-application of the EC Treaty rules in the EC; the issue should rather be addressed in the context of EC's external policy (see the 1994 Commission's guidelines on the application of State aid rules in the aviation sector, paragraph 11). Cf the different view of Advocate General VerLoren Van Themaat in Case 169/84, *COFAZ*, page 407, who argued for the admissibility of countervailing aid.
[240] And, even with respect to this more limited, act of self-defence, it is known how many voices of criticism have been raised. See, in general, Jackson (1997) page 279 et seq; Matsushita, Schoenbaum & Mavroidis (2003) page 262. The more comprehensive account is that of Trebilcock & Howse (2005) page 282 et seq.

1994, as interpreted by this Agreement'. The dispute settlement organs had the opportunity to interpret this provision with respect to the *US Byrd Amendment* (which provided that the proceeds of antidumping and countervailing duties should have been distributed to affected domestic producers). [241] In the recent *US – Offset Act* dispute, the Appellate Body considered the *Byrd amendment* as a 'specific action against a subsidy' and thus found it contrary to Article 32.1 SCM. [242]

Finally, as we will more diffusely see in the next chapter on the advantage analysis, it also seems that subsidies to compensate for disadvantages of a given domestic industry as compared with foreign competing industries are not *generally* accepted because of their direct interference with comparative advantages and hence with international competition and trade (as we will see, the case might be different when these specific forms of intervention are justified by certain circumstances – such as a regional handicap or a restructuring, or, certainly when *general* measures, that is measures applicable to the whole of the economy, are concerned). [243]

## Relevance of public objectives and various analysis levels

Having said that, it is certainly true that both subsidy rules and State aid rules may take into account the objectives pursued by governments when they intervene in the economy.

At the beginning, it has been anticipated that the analysis of the objectives of the governmental action may be one of the techniques to define the latter's legal relevance. According to the previous analysis, this seems, for example, to have occurred in a strand of the EC case law where the Court's negation that the measure at issue constituted a State aid seems to have partly been influenced by the purpose to compensate for some *disadvantages* faced, for various reasons, by the beneficiary undertakings (see the *Sloman Neptun*, *Kirsammer-Hack*, *Viscido*, *Cigliola* decisions

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[241] Quite interestingly, the intellectual origin of the Byrd Amendment might probably be traced back as far as to 1791 and the famous *Report on Manufactures* of Alexander Hamilton (see Lowenfeld (2002) note 1 at page 200).

[242] Paragraphs 263 to 274.

[243] The main authority in the field in the EC is Case 173/73 *Italy* v *Commission*, paragraph 13. See also Joined Cases 6 and 11/69 *Commission* v *France*, paragraph 21; Case C-6/97 *Italy* v *Commission*, paragraph 21. As for WTO law, see the Panel, *US – FSC*, paragraph 7.122. For a useful comment on the latter see Hudec (2003) page 189.

thoroughly examined above). Another argument, as said, might have been the *regulatory nature* of these measures.

It however seems that, on a proper construction of the rules, and in accordance with the consistent case-law that State aids should be defined on the basis of their effects, [244] public objectives should not be relevant, at least at the *very preliminary* level of the definition of the action of the government. A similar conclusion can certainly be drawn with respect to WTO law where, although it is often recognised that governments may act for various policy reasons, [245] the assessment of the action of the government is always maintained at an objective level (suffice to read the financial contribution element thoroughly analysed above).

Turning now to the observations that are of more general relevance for our work, we have to say that public objectives may in fact play a role – although a different one - in the legal analysis of rules but at *subsequent* levels. In particular, there is an interesting debate about their relevance at the level of the advantage analysis (see chapter 3) and of the effects analysis (chapter 5).

The reader has certainly recognised from the previous brief remarks one of the recurring themes of this work, ie the importance to distinguish between *scope* and *justification* (or, from another perspective, between *prohibition* and *justification*).

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[244] See Case 173/73 *Italy* v *Commission*, paragraph 13.
[245] See, for example, Panel, *US – Export Restraints*, paragraph 8.31; Panel, *US – Softwood Lumber III*, paragraph 7.16.

# IV. Bringing WTO and EC law together: critical and comparative analysis

## 1. Critical and comparative analyses, internal and external perspectives

In this final wrap-up section, our analysis will feature three different characteristics.

The writer first attempts to provide a *critical assessment* of the state of the law of what governmental actions constitute a subsidy or a State aid in the WTO and in the EC, and provide suggestions about whether the law (or its interpretation) should be changed. In other words, we mainly focus on the third question that we have put ourselves at the beginning of the chapter (what action *should* be considered a subsidy or State aid under the two legal systems).

Further, this critical assessment will be carried out from a *comparative* standpoint, that is the analysis of the similarities and differences between the *two* disciplines – and the *two* legal systems as a whole - will help us to better evaluate the correctness of the solutions adopted in *each* legal system.

Finally, our analysis will be divided into two parts, by adopting two different perspectives, which can indeed be seen as two sides of the same coin. On the one side, we will assess the regulation of subsidies and State aids *in itself* (which we may call *internal perspective*), focussing in particular on the concerns about *expansiveness* in terms of governmental actions covered.

On the other side, from what we could call an *external perspective*, we will briefly look at the other rules that in the two legal systems might apply to the same or similar forms of governmental action to address the worries about *system coherency*.

## 2. The regulation of subsidies and of State aids: the 'internal perspective'

### Recapitulation of the state of the law in the two legal systems

We should commence with briefly summing up the state of the law concerning the element of the action of the government in the two legal systems.

***WTO law***

In the WTO, the definition of subsidy in the SCM Agreement (Article 1) provides for a heavy reliance on the *forms* or *nature* of the action of the government. Mainly forms of financial assistance, as we have defined it at the beginning of the chapter, seem to be covered. With respect to the action through third parties, the exact scope of the rules of imputability under Article 1.1(a)(1)(iv) is still open. Although, as suggested, the wording seems to direct towards a strict reading – with the result that more complex forms of regulatory action would be excluded – we have recently seen an increasing relaxation of the standards with the result that it is at present difficult to make a precise assessment. Similarly, the exact remit of Article 1.1(a)(2), focussing on 'any income or price support', is still difficult to define with accuracy.

The examination of the AoA has provided some interesting results with respect to the forms of action covered, in particular with respect to the angle of the rules of imputability for indirect action. In particular, the test under Article 9.1(c), which covers payments 'financed by virtue of governmental action', expressly relies on a rule of imputability which is *less formalistic* than the ones examined under the SCM Agreement. What matters here is the *degree of causality* (which the Appellate Body calls 'demonstrable link') between the government's conduct and the financial support through an intermediary.

With respect to the 'cost to government', the Appellate Body seems to have definitely put this highly debated issue to rest by excluding its necessity under the definition of subsidy under Article 1 SCM, at least with respect to the cases of indirect action under Article 1.1(a)(1)(iv).

Finally, it does not seem that the pursuit of public objectives by the government through subsidisation plays any role at the level of the definition of the actions caught in the discipline.

### *EC law*

In the analysis of EC law we have focused on the only definition of State aid which is enshrined in the first paragraph of Article 87 EC.

Despite a broader language as compared with that of Article 1 SCM, we see a remarkably similar interpretation with respect to the forms of governmental action covered. In other words, it seems that only forms of financial assistance are covered by the provision with the exclusion of more complex forms of regulation. The arguments that are relied on to reach this conclusion partly refer to the *nature* or *form* of the measure (as occurs in WTO law), partly on the *objectives* of the measure, and partly rely on the use of 'State resources'.

With respect to the financing through public funds, it has to be highlighted that it is required of any form of support – be it financial assistance or regulation. It has also been seen that the test used to determine what constitute 'State resources' – ie whether they are 'under the control' or 'at the disposal' of the State – is not of easy application and the boundaries of the resulting coverage of the concept are difficult to draw with precision. A similar test of 'public control' is used as rule of imputability to determine whether the conduct of third parties can in fact be attributed to the State. It has however been seen that it remains open whether more complex and less direct regulatory mechanisms can in fact be covered by such rule or whether another, more comprehensive, rule of imputability could be found in the broad language of Article 87(1) EC.

## Critical and comparative assessment

After this brief summing-up of the state of the law with respect to the forms of public action covered in the two systems, the time has come for making a *critical* and *comparative* assessment thereof.

We may recall that the main worry of the 'internal perspective' is about *expansiveness*, that is about whether the scope of the relevant regulation is too comprehensive or, with a single word, excessive.

The issue is therefore where *boundaries* should be more appropriately set, which is indeed one of the *leitmotifs* of the thesis. In this regard, we may briefly note that there are two principal ways through which boundaries can be set in a regulation of subsidies or State aids.

On the one hand, and this is what is under scrutiny in this chapter, one route may be to directly deal with the *governmental action itself* and its characteristics. As we have seen, this may in turn require concentrating of the form/nature, imputability, financing, or objective of the measure.

On the other hand, one can draw boundaries to the discipline by focussing on the various aspects concerning the *impact* of the governmental action. We will see in the next chapters that this may be done by revolving around the *advantage* granted by the measure, by the – more or less specific – *subjective breadth of its impact*, and, eventually, by the – negative and/or positive – *effects* that are produced and *objective* that are pursued.

Having clarified that, we may commence with WTO law whose appraisal is quite straightforward, and, we may anticipate, *positive*.

We will mainly direct our observations on the main discipline, that is on the SCM Agreement, and in particular on the 'financial contribution' requirement, which we believe to be the most significant provision.

It seems to us that the balance struck by Article 1.1(a)(1) is sound. The difficult outcome of the fatigues of the negotiators, that is the wording of the financial contribution requirement, has been correctly construed by the jurisprudence of the dispute settlement organs (the only qualification concerns the perplexities raised by the Appellate Body in the *US – DRAMS* Report).

In substance, the financial contribution element, as interpreted by the dispute settlement organs, represents the medium way between the two extremes vigorously put forward during the Uruguay Round negotiations. On the one side, the US wanted to push through a definition of subsidy which singled out the benefits and effects produced by governmental intervention in the economy without paying any attention whatsoever to the form or nature of that conduct. On the other side of

the spectrum, the EC were focussing only on those forms of governmental action that produce a charge on the public account.

The solution of Article 1.1(a)(1) SCM is arguably a reasonable balance between these two positions: i) the form or nature of the financial contribution matter, ii) the origin of the resources does not matter. In sum, while rejecting the significance of the origin of the financial resources, the SCM mainly includes in the definition of subsidy only those forms of financial assistance that are generally considered as subsidies (and, conversely, leaves out the most controversial forms of regulatory action).

If we looked at the wider context, we cannot but underline how this middle position is certainly consistent with the current limited degree of economic integration of the WTO (cf the different EC context). In brief, this solution is in tune with a certain degree of deference towards the regulatory action of Member States (we may regard in this context the limited scope for harmonisation in the WTO, in particular as compared with the EC). Further, it is in line with customary rules of interpretation of the Vienna Convention, with their emphasis on the textual approach and the corresponding rather restrained role played by teleological arguments, particularly in a context, that of subsidy rules, where we have traditionally seen a significant disagreement between Members on the objective(s) of the discipline.

This latter argument leads us to consider the 'double-relevance' played by the definition of subsidy in the WTO regulation of subsidies where, beside the multilateral track (ie international obligations on the use of subsidies), there exists also a unilateral track (ie imposition of countervailing duty on subsidised imports). The problem is that a too excessively extensive definition of subsidy would risk expanding too much the resort to the – consistently criticized – countervailing duty path. [246] With an extreme, but, for this reason, forceful argument, Jackson (1997: 293-294) underlines how an unduly broad definition of subsidy would expose too many government measures to countervailing actions (which, we should recall, already constitute an exception to Article II GATT) with the ultimate risk of undermining the whole system of post-World War II GATT liberal trade. The

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[246] Particularly, if the major user so far of countervailing duty actions (the US) traditionally propends for an extensive notion of subsidy.

foregone conclusion is that 'the international system should be trying to define a subset of a certain type of "subsidy" with which it will be concerned'.

Having a single definition of subsidy for both 'tracks' (one controlling *subsidies*, one controlling *reactions to subsidies*), it was particularly important to reach a balanced interpretation of the financial contribution element. This would in turn have resulted in a balanced approach to the remedy-issue. The importance of this balance has been recently underlined by the Appellate Body whose findings deserve full quotation:

> ... the object and purpose of the *SCM Agreement* ... reflects a delicate balance between the Members that sought to impose more disciplines on the use of subsidies and those that sought to impose more discipline on the application of countervailing measures. Indeed, the Appellate Body has said that the object and purpose of the *SCM Agreement* is 'to strengthen and improve GATT disciplines relating to the use of both subsidies and countervailing measures, while, recognizing at the same time, the right of Members to impose such measures under certain conditions' [*US – Softwood Lumber IV*, paragraph 64]. [247]

Having assessed WTO law, we may now pass to EC law. For the sake of fairness, the result of the appraisal should be anticipated in this case too. The current state of the law with respect to the forms of governmental action covered by Article 87(1) EC, particularly as it results from the interpretation thereof, is substantially *unsatisfactory*.

The main, general finding is that the scope of EC State aid rules (at least with respect to the forms of governmental action covered), is *substantially equal* to, if not even, *narrower* than that of WTO subsidy rules.

This is indeed paradoxical as we would have expected a different coverage but, arguably, the other way round, with WTO proceeding at a slower pace.

Unlike the financial contribution requirement in Article 1 SCM, Article 87(1) provides for a broad and potentially comprehensive language: 'any granted by the State or through State resources in any form whatsoever'. This provision, and its wording, should be set in the broader EC context where we certainly have a higher

degree of economic (and not-only) integration between its Member States, and where, consequently, the approach to interpretation is quite flexible, being characterised by a heavy reliance on teleology.

These elements – broader language, higher integration, more reliance on teleological arguments – would all together lead to a comprehensive reading of Article 87(1) EC from various perspectives.

It could be argued that Article 87(1) should not cover only the more commonly accepted and traditional forms of financial assistance but also the more complex forms of regulatory action. Thus the reference to the *form* or *nature* of the action of the government should not be relevant. And, as suggested, the consideration of the *public objectives* of the measure at the level of the definition of the action is not in line with the consolidated emphasis on the *effects* of the measure and hence does not seem correct.

With respect to indirect action, we should – and, admittedly, the quite flexible *Stardust* test might lead in this direction - expect a quite loose approach to the rules of imputability, much more resembling the *causality* approach that we have found in Article 9.1(c) AoA than the more *formalistic* one of Article 1.1(a)(1)(iv) SCM.

Finally, the repeated – and now consolidated – reference to the necessity of a use of 'State resources' should be put aside as it does not make much sense from the perspective of the competition purpose of the discipline (particularly in the context of an *increasingly completed* internal market). What matters is that an undertaking or an industry receives an unfair economic advantage and not who is burdened. [248] Moreover, the loose criterion of public control which is used to define what constitutes 'State resources' is uncertain – if not contradictory - when it comes to its actual application. It may even be suggested that the reliance on the argument of 'State resources' can be viewed as a *technical surrogate* for disposing of certain forms of action based on their regulatory nature or their objectives.

Further, considering the remedy-side, we should underline that, contrary to what happens in the WTO, in the EC Members do not have the possibility to resorting to

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[247] *US – DRAMS*, paragraph 115.

unilateral defensive measures such as countervailing duties. The argument put forward in the WTO in support of a balanced – better, cautious – interpretation of Article 87(1) with respect to definition of State aid would thus not be applicable.

To explain the restrictive approach of the EC towards certain regulatory measures and towards the issue of financing, a comparison is appropriate. It is interesting to consider the interpretation of State aid in EC 'internal' law together with that of subsidy in EC external relations (the one defended during the Uruguay Round negotiations).

With respect to the latter, it seems indeed that the motive that has led the EC to introduce the 'cost to government' requirement was to limit the concept of subsidy and through this keep at bay the aggressive use of countervailing duty actions made by the US. Interestingly, this additional element was required of the definition of GATT subsidy at the same time when, in EC law, the concept of State aid was generally held (surely so in Commission's policy) not to demand a use of 'State resources'. [249] It has thus been suggested that 'the Community seems to have elevated a tactical move to the level of policy'. [250]

A similar attempt of limitation can be found in the restrictive interpretation of the definition of EC State aid. This move, which is heavily based on the requirement of 'State resources', is aimed at excluding certain forms of *regulatory measures* from the coverage of State aid rules. This may *partly* be explained for reasons of constitutional deference towards Member States' policies. We said 'partly' because, as we will see, the non-application of State aid rules does not necessarily preclude the application of other EC rules.

This attempt to exclude certain regulatory measures from the coverage of State aid law can be put in its historical momentum. Cases such as *Sloman Neptun* and *Kirsammer-Hack* belong to the same generation of *Keck*. [251] Both produced the

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[248] As we have underlined, the method of financing, and in particular the use of public money, is relevant at the level of the assessment of the *impact* of the State aid and not of its definition.
[249] See the examination of the 'first period' of the case law on the 'State resources' requirement above. For the position of the Commission reference is once again made to what the latter argued in the *Fediol* cases (Case 187/85 and Case 188/85): see respectively paragraphs 32 and 34 of the two Report of the Hearing.
[250] Bronckers & Quick (1989: 18). See also Slotboom (2002: 532).
[251] Joined Case C-267 and 268/91 *Keck* was decided on 24th November 1993. While *Kirsammer-Hack* was passed only 6 days afterwards, its precursor, *Sloman Neptun*, was judged a few months earlier (17th March). On the link between *Keck* and the other State aid cases see Davies (1995) page 59; Ross (1995) pages 82 and 83.

limitation of the scope of, respectively, Article 87 and Article 28 EC by sheltering, although in different ways, 'certain' *regulatory measures.* [252]

[252] It is important to make two remarks. First, although partly overlapping the concept of 'regulation' is used in different senses in the two contexts (in the State aid context it is opposed to 'financial assistance', in the internal market context to 'restrictions to trade' which may well include regulatory requirements concerning, for example, products' composition and packaging). Secondly, *Keck* does not exempt 'certain selling arrangements' from the scope of Article 28 EC altogether, but merely prohibits discriminatory measures.

## 3. The other rules: the 'external perspective'

Although the findings of the internal perspective are already significant, in our quest for boundaries we might also *briefly* look at the external perspective of subsidy and State aid rules, that is at the other rules that might in principle apply to measures which may be classified as, or are similar to, subsidies or State aids. This 'external' analysis is directly linked to the concerns about *system coherency* which, as anticipated, represent the other side of the coin of the concerns about the *expansiveness* of subsidy and State aid rules.

Before commencing this analysis, two remarks should be made. First, the following observations are not confined to the more limited issue of the public intervention but more generally concern all aspects of subsidy and State aid regulation. Further, what is attempted to do here is merely to sketch a problem-framework. In other words, the writer will raise *issues* rather than providing *answers*, as the matter is huge and goes beyond the research topic.

### Sketching the terms of the problem: rules and system

As a matter of principle, it can immediately be underlined the importance of setting each set of rules in its wider context. In other words, (at least) academic lawyers should try to look at legal systems as *coherent* systems where the scope of the various sets of rules, and the relationships between themselves, are well-defined.

In the current context, the main issue when we are dealing with concerns about *system coherency* is whether measures that are alleged to be caught by subsidy or State aid rules should more appropriately be covered by other rules.

A linked, and delicate issue, is that of *circumvention of the law* or, with another wording, of *policy substitution*. The legal system may present a lacuna or a gap in the regulation (which, to be as such, should always be non-deliberate and unjustifiable) enabling certain courses of conduct that *should* be regulated by a certain set of rules to fall outside the scope thereof (or, even, of any rule altogether).

Crucially, the application of different rules often involves a *different substantive regulation* (for example, with respect to the definition of the scope of application and of prohibitions/justifications). Further, *different procedural rules* may be applicable with an important impact on the institutional and, even, constitutional side.

## Rules overlap and system coherency

It is sometimes argued that a too expansive scope of subsidy and State aid rule would entail a danger for the coherency of the system. The issue, however, is whether there is any such thing as *system coherency* with respect to those measures that may be covered by subsidy and State aid rules (and indeed even from a more general perspective).

In this regard, it may be particularly useful to commence with a quotation of Professor Ehlermann (2002: 630) who, in a recent account of his experience on the bench of the Appellate Body, made the following considerations by drawing from his twofold experience as EC and WTO lawyer:

> [f]rom the beginning, I have been impressed by what seems to me to be a rather important difference between the two legal orders. Substantive WTO law appears to me to be less structured than EC law. The same contested measure is often examined under a series of provisions, possibly contained in different covered agreements. All of these provisions and agreements seem to apply simultaneously and cumulatively. There seems to be no – or at least little – structure, and overall architecture, which would allow distinguishing between *lex generalis* and *lex specialis*.

The author then drew some examples. Quite interestingly, one of them was the 'relationship between the GATT, the GATS and the Subsidies Agreement'. He concluded by asking 'whether it would not be necessary (or appropriate) to determine a dividing line between these three agreements, in order to avoid a systematic overlap of the three texts'.

The previous observations are precious and constitute a good starting point for our brief analysis (which, as said, will raise more issues rather than offering answers).

The most important consideration is that, despite any systemic uneasiness, it is a *matter of fact* in virtually any legal system that the same measure (or different aspects thereof) may be regulated by different provisions. Certainly this may cause some problems with respect to the applicable law, the procedure to follow, and the institutional/constitutional share of competence. But, as said, these situations of overlap do indeed take place and, to a large extent, the interpreter has to live up with them.

This seems to occur both in EC and in WTO law with respect to subsidy and State aid.

If we look for example at EC law, Biondi & Eeckhout (2004) underline how the case-law, although seemingly referring to the aspect of the measure under scrutiny, does not provide a clear divide between internal market rules and State aid rules. Admittedly, a quite clear distinction exists between specific measures distorting competition (covered by State aid rules) and general measures distorting competition (which may, in principle, be subject to harmonisation).

In general, it seems that a similar situation – as underlined by Ehlermann - would occur in WTO law. There are indeed no special reasons why a measure falling within the scope of subsidy rules should not be covered also by other provisions such as Articles II, III or XI GATT.

As said, however, the application of one rule rather than another has indeed different implications.

The case of WTO is particularly instructive. The most important peculiarity is that to consider a measure as a subsidy may open the way to the imposition of a unilateral countervailing duty on the relevant imports, which would not occur if the same measure is covered *only* under Article XI or III GATT (or indeed Article II GATT to which Article VI – permitting countervailing duties – is just an exception …).

Other interesting systemic observations are raised if we consider justifications. To classify a measure of financial support as a trade-barrier covered by Article XI GATT or as a discriminatory regulation under Article III:3 GATT opens up, at least in principle, the possibility of applying the justifications under Article XX GATT.

If, by contrast, the same measure is examined under subsidy rules, the possibility of justification seems to be much more limited in scope. It seems indeed that we should only resort to the category of 'non-actionable subsidies' under the SCM, the latter being a development of the GATT provisions on subsidies. [253]

The issue becomes particularly intriguing if *both* sets of provisions (GATT provisions and SCM provisions) are held to apply cumulatively. Does a justification under one agreement, for instance the GATT, suffice to shelter the practice from the wrath of the other agreement, say the SCM? Further, considering that the category of 'non-actionable' subsidies is for now dead letter, can the general justifications under Article XX become relevant again also with respect to the subsidy issue?

As the previous non-exhaustive analysis has shown, there are many interesting systemic issues, which would well deserve further research. What, in our view, can already be said is, however, that whatever outcome this research should produce, our findings based on the 'internal perspective' above should substantially remain safe. This is mainly due to the previous observation that the overlap between different provisions is an inevitable matter of fact in any legal system.

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[253] It should, however, be recalled that, at least under the current state of the law, our reasoning is purely speculatively. The category of 'non-actionable' subsidies has expired in the year 2000.

# Chapter 3

# The advantage analysis

## I. Scope of the chapter

The legal definition of the concept of advantage is the subject of this chapter. This element, which is inherent in both notions of subsidy and State aid, refers to the possession of economic resources that the beneficiary undertaking receives from the government.

The importance of the concept of advantage, and hence of this chapter, can be appreciated if this element is placed in context. The advantage produced by the public intervention in the economy is the crucial factor that eventually makes the subsidy liable to produce negative (in the form of distortion of international competition and trade) and/or positive (in the form of remedy to an undesired socio-economic situation) effects.

The following sections explain the process to determine the existence of an advantage in the two systems, ie the *advantage analysis*, and the main difficulties emerging therefrom.

The first part introduces to the basic notions of comparison and benchmark, the underlying core idea/test of derogation from the norm, and the political and economic context of the advantage analysis. The exposition then follows a two-fold pattern, depending on whether the public intervention occurs in the market or outside it. The role played by the public policy objectives pursued by governments through subsidies is thoroughly examined. A case-study on the issue of the financing of public services closes the chapter.

## II. Introduction: the advantage analysis

### 1. The steps of the analysis

In *Canada - Aircraft* the Appellate body laid down findings whose generality makes them suitable for explaining the operation of the advantage analysis in both legal systems.

As expressed by its ordinary meaning, the concept of 'benefit' under Article 1.1(b) SCM 'clearly encompasses some form of advantage'. [254] This intuitive, still skeletal, idea, the need that the governmental conduct somewhat confers an *economic advantage* (ie an increase of financial means or revenue, or a decrease of costs), is immediately given flesh:

> the word "benefit", as used in Article 1.1(b), implies some kind of *comparison*. This must be so, for there can be no "benefit" to the recipient unless the 'financial contribution' makes the recipient "better off" than it *would otherwise have been, absent* that contribution. In our view, the marketplace provides an *appropriate basis for comparison* in determining whether a "benefit" has been "conferred" ... whether the recipient has received a "financial contribution" on terms more favourable than those available to the recipient in the market. [255]

The added emphasis highlights the main steps of the advantage analysis.

The determination of the conferral of 'some form of advantage' is based on i) 'some kind of comparison' which in turn requires ii) an 'appropriate basis' for it, that is an appropriate benchmark. [256] Crucially, this comparative process should lead to determine whether the recipient is 'better off' than iii) it 'would otherwise have been, absent' the government measure.

These findings are examined in turn.

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[254] Appellate Body, paragraph 153; cf also Panel, paragraph 9.112

[255] Appellate Body, paragraph 157 (emphasis added); cf also Panel, paragraph 9.112

[256] Incidentally, the reference to the marketplace depended on the circumstances of the case - the government was acting on the market – and this should not necessarily be considered as a rule in all cases.

## 2. The basic concepts: comparison and benchmark

Basics first. The Appellate Body noted that the advantage analysis depends on a comparison of the measure at issue against the appropriate benchmark. This conclusion is plainly transposable to Article 87(1) EC. Advocate General Cosmas noted that the concept of advantage is based on the ideas of 'comparison' and 'point of reference'. [257] Similarly, it has been underlined that '[n]o advantage can be identified without a comparator first being found as a benchmark for treatment.' [258]

Common sense is sufficient to understand this point. The question of whether one has received an advantage immediately begs another question: advantage *in relation to what*, *in relation to whom*? This means that it is necessary to make a comparison and, to do so, to find a suitable benchmark. This exercise discloses whether any advantage has been received.

The 'appropriate' benchmarks may be disparate. The government may intervene, and produce an impact, in the economy, in two broad ways. This distinction is important to identify the correct benchmark. If the public body performs an *economic* activity in the market, this conduct is tested against the *market* benchmark applicable in the circumstances. If, by contrast, the public body carries out a conduct which is *not economic* but inherently governmental, the suitable benchmark will be *normative* since it has to be found in the relevant regulation.

It is worth underlining that the two-fold distinction between *economic* and *non-economic* activity, and *market* and *normative* benchmarks, is not based on the *objectives* pursued by the government (which in either case are presumed to be for the common good) but rather on the *nature* of the action. This important point is clarified further in paragraph 4 below.

## 3. The operative test, or how the analysis works

So far, we are still at a superficial level. To say that the advantage analysis implies 'some kind' of comparison and that an 'appropriate' benchmark needs to be found

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[257] Case C-353/95P *Ladbroke*, paragraph 30 of the Opinion.
[258] Ross (2000b: 407).

(be it a market or normative one) is still descriptive. It does not explain how this analysis works and, eventually, how the determination that an advantage has, or has not, been conferred can be made. To do so the comparative process mentioned above has to be embodied into an *operative* test.

The findings in *Canada – Aircraft* provide again a useful indication.

The Appellate Body noted that the comparison refers to what 'would otherwise have been' in absence of the measure at issue and, in the case of economic activity, to whether the measure has taken place on 'terms more favourable than those [otherwise] available in the market' (in the latter phrase the term 'otherwise' has been added by the writer, assuming that this concept can be safely implied from the context).

## The derogation test: norm and deviation

The key to define the operative test – the third step of the advantage analysis - is the construction of the idea of 'otherwise available' which is referred to by the Appellate Body in both sentences.

This wording hints at two ideas. First, it crucially defines the *benchmark* with reference to an idea of *norm* or *normality*. This is not an absolute standard but a relative one. What is the otherwise applicable - the 'appropriate' - norm depends on the circumstances of the case, and mainly on the distinction made above between economic and non-economic activity.

The second idea that can be derived from the 'otherwise due' language is that the advantage would be the result of a *derogation* from the appropriate benchmark-norm. This *(derogation) test* is a serious candidate for the operative test giving shape to the 'comparison with an appropriate benchmark' underlying the advantage analysis.

This analysis finds confirmation in EC law. In the early *Steenkijomenen* case, the Court of Justice laid down a statement which has become standard in the case-law. The concept of aid

> embraces not only positive benefits, such as subsidies themselves, but also interventions which, in various forms, mitigate the charges that are *normally* included in the budget of undertakings ...' [259]

The idea of (departure from) normality underlying the concept of aid is clear and supports the previous construction of the test of the advantage analysis. Two illustrious Advocate Generals of the Court underlined that it is necessary to establish whether there is an economic advantage which would not have been granted in the *normal course of events.* [260] With a general language, referring to a market transaction, the Court itself found that

> in order to determine whether a State measure constitutes aid, it is necessary to establish whether the recipient receives an *economic advantage* which it would not have obtained *under normal market conditions.* [261]

Whereas the EC language expressly refers to the idea of normality, also the idea that the existence of an advantage would result from the derogation from this norm seems to find an implicit, albeit logical, confirmation. [262]

All this leads to the conclusion that the 'derogation from the norm' is the operative test we were looking for, the core paradigm of the advantage analysis.

## Variations on the theme: defining the norm, determining the exception

Sometimes a different formulation of the test to establish the advantage can be found. This echoes the principle of equality (or, negatively, the prohibition of discrimination) and focuses on whether the *situation at issue is treated like comparable situations.* In interpreting the phrase 'otherwise due' under Article 1.1(a)(1)(ii) SCM (which concerns the taxation activity of governments), the Appellate Body found

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[259] Case 30/59 *Steenkijomenen*, page 19 (emphasis added).
[260] Cf Advocate General Slynn in Case 84/82 *Germany* v *Commission*, page 1501; Advocate General Jacobs in Cases 278 to 280/92 *Hytasa*, paragraph 28.
[261] Case C-39/94 *SFEI*, paragraph 60 (emphasis added).
[262] An express reference to a 'derogation from the norm' can be found in the Commission's practice with respect to taxation and State aid. See below.

that 'like will be compared with like' and that it is necessary to 'compare the fiscal treatment of legitimately comparable income'. [263]

This variation can also be found in EC law. In *Adria-Wien* the Court noted that the question is whether a State measure favours certain undertakings 'in comparison with other undertakings which are in a legal and factual situation that is comparable in the light of the objective pursued by the measure in question'. [264] Advocate General Cosmas expressly linked the prohibition of State aid to the principle of equality. [265] This linkage to a general principles discourse has been nicely elaborated by a scholar: 'the prohibition of State aid appears as a result of the general principle of equality, and the rule derived from it that a like rule should apply to like situations'. [266]

All these formulations lay down what can be dubbed as 'comparative test'.

What is interesting to ask is whether there is a link between this idea of comparison of similar situations - and its underlying rule of equal treatment, or, to put it differently, of non-discrimination - on the one hand, and the idea of derogation from the norm on the other. Are these two tests different? Or, more simply, do we have two formulations of substantially the same test? Although this issue has come out prominently in the *US – FSC* dispute, and is comprehensively dealt with below, it is believed useful to anticipate the main findings.

The derogation test directly focuses on the logical process to determine whether the measure at hand grants an advantage (by expressly using the suggestive language of *derogation* or *exception*). The other formulation seems to be more low-profile from this perspective (usually referring to the quite neutral concept of comparison rather than to the more expressive idea of discrimination). The comparative test is however particularly instructive when it comes to define the appropriate benchmark used in the derogation test. It will be seen that the reference to 'comparable or like situations' represents the core concept around which the notions of general rule or norm should be defined.

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[263] *US – FSC (Article 21(5))*, paragraphs 90 and 91.
[264] Case C-143/99 *Adria-Wien*, paragraph 41.
[265] Case C-353/95P *Ladbroke*, at paragraph 30 of the Opinion.
[266] Ross (2000b: 407, emphasis added).

The substantial identity of the two tests is confirmed by the fact that their languages are always overlapping (also in this thesis). There may be a reference to the existence of an *exemption* from the rule or to a *differential treatment* between undertakings. In both cases, the subsequent issue is whether this apparent anomaly is in fact justified. Whatever language is used, the underlying process is the same and requires a complex analysis which focuses on similarities and differences, objectives and justifications, and eventually rules and exceptions therefrom.

Whilst the intrinsic mechanics is the same, the 'comparative' and 'derogation' tests usefully *emphasise* and *clarify different steps* of the advantage analysis (respectively what the norm is and what the exception is). The writer's choice to refer to the 'derogation test' as the paradigm of the advantage analysis is simply dictated by the belief that this formulation better conveys the ideas of *deviation* (or discrimination) that is eventually crucial in determining the conferral of an advantage.

To conclude, a music aficionado would say that the two formulations are variations of the same theme rather than two distinct themes. Like variations in melody, rhythm, harmony or ornamentation show different facets of the theme to the benefit of *beauty*, conceptual variations in law, and indeed in other scientific areas, may clarify different issues to the benefit of *better understanding*. To seek beauty in law would probably be overambitious.

## 4. The context of the advantage analysis: market liberalization and public role redefinition

### Market liberalization and social welfare recognition

The advantage analysis, and more generally the debate on public subsidies, can be understood only if the more general economic and political context is properly considered.

The current times have seen the emergence of two phenomena which involve strong cultural and ideological, financial and political forces.

First, there is a trend, well known at least in western economies, towards *liberalization* of the economy and *privatization* of public undertakings. [267] Sectors that till recently were public reserves (such as health, education, transport and public utilities – post, communications, water, electricity, gas) are increasingly liberalized and privatized. The role played by private actors in the provision of theses services is more and more significant. This depends on various reasons, which can be fairly summed up in the belief that competitive markets are more beneficial to consumers and that the private sector is able to operate more efficiently. Ultimately, the greater budgetary constraints faced by governments also contribute to the reconsideration and retreat of direct public intervention in the economy.

What governments are not retreating from is their main purpose and justification, the *pursuit of the public interest.* Whereas the means to reach it may change, for example regulation instead of direct provision, the social dimension of public action faces a renewed recognition. [268] The most notable example is the current debate on public services that can be seen in many legal and political contexts, including the EC and the WTO. [269]

These two phenomena underlie the current *redefinition of the public role in the economy* which also offers the opportunity for a *conceptual clarification* which is fundamental for the advantage analysis.

## Public role redefinition and conceptual clarification

Liberalization and privatization are leading to a crucial redefinition of the role of governments in the economy. Governments are increasingly changing from *providers* to *regulators.* [270] Many activities, such as the provision of infrastructure or public services, which were typically supplied by the government and traditionally considered public, increasingly involve at various stages private actors.

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[267] See, in general, Stiglitz (2000: Chapter 1).

[268] For two recent and interesting collections of essays of the EC debate see De Búrca (2006) and Dougan and Spaventa (2005). The need to 'take action to *redistribute opportunities* in favour of the poor' is also an increasingly topical debate in the governance of the world trading system. For a general discussion and references see Van den Boosche (2005: 29-35)

[269] For various references the reader is referred to the last section of the chapter.

## Economic and non-economic activities

The redefinition of the role of the public intervention in the economy calls for a *conceptual clarification* between i) those activities that are truly *non-economic* because, even hypothetically, they would not be carried out be private agents and are thus inherently public, and ii) those that, although involving a public interest and thus the responsibility of the State, are *economic* because may take place in a market scenario and be ruled by market logic.

This distinction is crucial for the operation of the advantage analysis because it tells us what is subject to the market, its logic and rules (ie *economic* activity), and what is not (*non-economic* activity).

A brief exposition of some basics of welfare economics, and in particular the distinction between public and private goods, may be useful to better understand this important conceptual divide. [271]

### *A primer on public, private and publicly provided private goods*

Economics teaches us about two key concepts, those of *public* and *private* goods. Public goods are those goods or services which, if provided, are open to use by all members of society. [272] Conversely, private goods are any good or service which if used by one individual or firm are not available to others. [273]

More specifically, public goods are characterised by the fact that it is not possible to exclude any individual from the benefits of the good without incurring great costs, so-called *excludability*. Another property, less significant for the purposes of this analysis, is that of *non-rival consumption*. [274]

*Pure* public goods, ie those goods or services that clearly fulfil both properties above, are rare (eg defence, lighthouses, street-lighting).

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[270] This phenomenon has been analysed by many commentators. See, eg, Majone (1994); La Spina and Majone (2000). For other references the reader may wish to consult the general work of Cave and Baldwin (1999).

[271] The following exposition substantially draws from the clear and authoritative work of Stiglitz (2000: Chapters 6 and 8).

[272] Black's Dictionary of Economics (2002: 379).

[273] Black's Dictionary of Economics (2002: 368).

[274] This means that public goods can be used simultaneously by more persons without this causing any particular additional cost.

The importance of the distinction between public and private goods is that, under the common premiss that private agents normally act rationally (ie selfishly: sic!) and not altruistically, public goods are *not* normally supplied by the private sector, mainly because individuals cannot be excluded from, and hence charged for, their use. For this reason, they are considered a paradigmatic example of market failure which justifies the public intervention. Although we return on the concept of market failure, it may be useful to quote the clear notion suggested by Friederiszick, Röller and Verouden (2006: page 13, note 34):

> markets fail when the market (based on private actors) does not provide a good or service even though economic benefits outweigh economic costs. This happens when the private benefits (or costs) are not equal to the public benefits (or costs).

It can quite safely be assumed that the large majority of goods and services should be regarded as private since there are usually means to exclude from and charge for their use. In other words, the crucial finding is that, at least hypothetically, most of the goods and services can be provided by the private sector.

There are however certain cases, mainly involving *public services*, which are more controversial. For example, whereas Stiglitz (2000: chapters 6 and 8) does not seem to include them among public goods, others, like more recently Friederiszick, Röller, Verouden (2006: 13), seem to share a different view.

The remainder of the analysis attempts to explain this diversity, and suggest a tentative solution.

As explained by Stiglitz (2000: chapters 6 and 8), many goods or services that, strictly speaking, may be considered private goods – because exclusion is possible - have been often directly supplied by the public (so called 'publicly provided private goods').

Leaving aside the political, cultural or ideological reasons, which may have had an impact of this choice, according to economics the provision of *private goods* by the government may be justified for either *efficiency* or *equity* reasons.

For example, private agents may run hospitals and schools or universities. However, there is usually a large marginal cost associated with supplying additional individuals. This may result in fairly *high prices* being charged on patients and students. The government may thus think it fair to provide these services directly for a lower fee or indeed free of charge. This is an *equity* justification.

Another example is where the existence of *increasing returns of scale* (ie where productivity increases with output) [275] may make markets not competitive because economic efficiency requires that there are only a limited number of players. In some industries, called *natural monopolies* (notable examples are some public utilities and transportation), the increasing returns of scale are so important that the market can support only one firm.

The creation of a substantial infrastructure, usually a *network*, to provide the service may involve considerable *sunk costs* (that is costs that cannot be recovered by the undertaking if it ceases operation even in the long run). [276] Although the marginal additional cost for supplying the actual service may be relatively insignificant, the sunk costs associated with the network creation may represent a substantial investment as well as a crucial barrier to entry for would-be competitors. The incumbent may thus be in the position to exploit its monopolistic power and exploit consumers with high prices. This failure of competition is an *efficiency* justification for the public provision of what in general are private goods.

It is worth repeating the point. In both these cases, either for equity of efficiency reasons, the government often provides goods and services that the private sector may well provide. Alternative ways of providing them may indeed be *possible*. As the current liberalization/privatization trend clearly shows, the private sector is increasingly involved in their supply. However, to ensure efficient and equitable outcomes, governments may still intervene, complementing private production with regulation and/or subsidization (and taxes).

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[275] Black's Dictionary of Economics (2002: 226).
[276] Black's Dictionary of Economics (2002: 452)

A good example is that of 'universal service obligations'. The government may wish to ensure that certain essential services should 'be offered at affordable price in order to be accessible to everybody'. [277]

If the private supplier is not in the position to guarantee this 'affordable price to everyone', for example (in the common case of postal services) because mail delivery in remote areas is particularly costly for the supplier (and hence too expensive for the consumer), some form of public intervention may be needed. Otherwise, neither the necessary infrastructure nor service will be provided.

We can concentrate on the provision of the service because it is its economic viability which is crucial (and *directly* influences the decision to create or extend the network).

Apart from direct subsidisation by the government (more commonly to the supplier of the service than to the user), a uniform price for all consumers throughout the country may be set. Crucially, if the financial viability of the supplier has to be ensured, cross-subsidisation between the more profitable users (who will pay more than the marginal cost for the service) and the less profitable users (who will pay less than the marginal cost) is needed. So far, no public intervention is necessarily needed.

The government *may* need to intervene if there is a risk that others might decide to enter the market and 'cream off' the most profitable part of the business (in the example of postal services, urban areas) by charging at *just* the marginal cost. The public tool to ensure the financial feasibility of the uniform price may thus be the grant of an exclusive right to the supplier, ie a monopoly in the relevant business.

The case of 'universal service obligation', which *inter alia* includes the idea of affordability, is particularly instructive because it shows that, whereas in general the private sector may well deliver the relevant services, there *may* still be a need for further public intervention if, mainly for equity reasons, the private sector is *required* to supply them *at certain conditions*.

It is indeed the weight given to these *regulatory requirements* which, in our view, explains the divergence among those that consider these service as private goods -

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[277] See the Commission Green Paper on Services of General Interest (2003: 60-64).

focussing on the fact that *in general* they can be performed by private agents -, and those that regard them as public goods - arguably concentrating on the fact that the supply under certain conditions *may* require some form of public intervention because it somewhat increases the 'cost of exclusion'. Depending on the importance attributed to this factor, the definition of public good is accordingly narrower or broader.

The writer's tendency is to follow the first group, and their more abstract approach. The main reason is because, like in the case of education and health, these services may generally be performed by private agents. It is an *equity*, or with another word, *policy* reason which justifies either their direct provision by the government, or the imposition of certain standards and obligations and hence some form of public intervention to assist the private to reach them. In other words, these services can be provided by the private sector which, following the definition of private goods, can exclude from, and charge for, their use. [278] It is the resulting price which in the end may be not acceptable (by the government and/or the users) and may justify the interference of the government. [279]

### *Teachings from economics*

The writer's proposition is that, despite its difficulties, the debate on private and public goods is ripe with teachings for the advantage analysis of public intervention in the economy.

The first important finding is that the distinction between *economic* and *non-economic* activities, and market and normative benchmarks, should closely follow the distinction between respectively private and public goods. Hence, whereas a non-economic activity is one that, *even hypothetically*, is not provided by private agents, an economic activity can be supplied by the private sector.

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[278] Downgrading the 'market failure' rationale for infrastructures, Santamato and Westerhof (2003: 646) observe that 'non-excludable [public] goods are not very frequent: for most infrastructure there are technical means of charging a price for the use of the facility'.

[279] It should be underlined that, so far, we have talked about pricing but there is also another important variable in the equation, which is the quality of the goods and services supplied. Whether, and under what conditions, public intervention may guarantee a higher quality is a huge issue which would deserve more attention than that permitted here.

Admittedly, this distinction is not always fully clear. We may have cases where, out of altruism or ostentation, private agents provide public goods. At the same time, as has been seen, the definition of the boundary between public and private goods may not always be easy to draw. It could be argued that, to some extent, it depends on the circumstances of the case at hand (it has been said that the distinction is a matter of 'degree') [280] and on the more general context which may change, and rapidly. The Commission has, for example, observed that the concept of universal service obligation is 'dynamic and flexible' and that it should be 'redefined periodically in order to be adapted to the social, economic and technological environment'. [281]

Despite these uncertainties, the writer believes that the economic distinction between public and private goods provides a reasonably sound standard (at the very least a good rule of thumb) to distinguish between *non-economic* and *economic* activities for the purposes of the advantage analysis.

The second important teaching is that it is not possible to equate i) the concept of *responsibility of the government* with ii) the concept of *inherent governmental* activity.
The example of infrastructures is clear in this regard. These are crucial to the socio-economic development of a country and are often necessary for the supply of public services. Being in the public interest, the proper planning, creation and maintenance of infrastructures (and public services) is undoubtedly part of the *responsibility* of governments. The analysis of the previous paragraph seems however to indicate that they do not necessarily have to be provided by the government (in our jargon they are not an *inherently public prerogative*) but can generally be provided by private agents.

## Public interest between scope and justification

The previous examination of the ways through which the public interest may be pursued gives the opportunity to introduce one of the recurring themes of the thesis, which is the analysis of the interplay between *scope* and *justification*.

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[280] Stiglitz (2000: 134-135); Black's Dictionary of Economics (2000: 369).
[281] Commission White Paper on Services of General Interest (2004: 3.3).

This issue, which has a huge political and legal impact, enquires the role played by the public interest at the various stages of the legal analysis of the regulation of subsidies and State aids.

Rephrased differently, the question is about *what is covered* by the rules and ***what is permitted.*** Two scenarios are indeed possible. In the first, the conduct is not caught at all by the rules. The pursuit of a public interest, which is considered at the very preliminary stage of the definition, leads to the conclusion that there is no advantage. In the second scenario, the presence of a public interest does not preclude the conduct from granting an advantage. If the other requirements of the definition are fulfilled the measure falls within the scope of application of the rules and, in some cases, is prohibited. However, the pursuit of a public interest may be recognised at a further stage of the analysis, when special exception-provisions come into play, and the conduct may eventually be permitted.

Unlike in other contexts (see, for examples, the definition of 'service' and 'undertaking' under various provisions of EC law), the determination of whether the conduct is economic or not does not have a direct impact on whether the measure falls or not within the scope of application of the law. In the context of the advantage analysis, the goal of the classification is the identification of the appropriate benchmark – market or normative – to test the conduct at issue and eventually determine whether it does derogate or not from the appropriate norm.

The issue of whether the conduct is economic or not is not however is fully neutral.

A first distinction immediately comes out. Whereas in case of non-economic conduct the benchmark is the general rule in the area which, in its own choice, the government had defined, the standard to test a public economic activity, ie the market, is by definition external to any form of interference.

Further, it cannot be denied that to define a conduct as economic, and to subject it to market logic, might actually result in a stricter standard to adhere to, at least in some circumstances (this may for example depend on how abstract/concrete the benchmark actually applied is).

With more specific regard to the scope/justification issue, the economic classification makes the identification, and separation, of public policy

considerations, easier. This is more difficult when we are fully in the realm of non-economic conduct where public motives are intertwined among themselves. A public interest objective is more likely to be invoked at the level of the advantage analysis, arguing that there is no discrimination or derogation and, consequently, that the measure falls outside the scope of the rules.

The following sections analyse what role the public interest does, or should, play in the context of the advantage analysis with respect to both economic and non-economic governmental activities.

## III. Economic activity and market benchmarks

Whereas the next section concentrates on the advantage analysis of the forms of conduct that are non-economic and hence inherently public, such as taxation and regulation, this section focuses on the economic activity of governments.

The first part deals with the general principle of the market. The focus is on the exposition of the complexities and difficulties involved in the application of the actual benchmarks derived from this paradigm.

In the second part, two case-studies explain the relationship between public intervention in the economy and market benchmarks. The attempt is to show, in the current context of redefinition of the roles of public and private actors in the economy, the interplay of two contrasting forces and their critical impact on the advantage analysis.

A shift from the complexity discourse to the outspoken criticism is the subject of the final part. The fundamental critiques about the possibility and legitimacy of using market benchmarks to test the economic conduct of public bodies are examined, and followed by an attempt to provide a balanced rehabilitation of the market paradigm.

### 1. The market: a complex paradigm

#### The adoption of the principle

The market has been elevated to the status of one of the most important paradigms of the advantage analysis. This is just half of the story however. Although based on an arguably solid rationale, it will become immediately apparent that the application of this principle is not free from complexities and difficulties.

#### From the reticence of the law to the consolidation of a paradigm

Article 1.1 SCM provides that a subsidy shall be deemed to exist if a 'financial contribution' or a 'form of income or price support' confers a 'benefit'.

However, the concept of 'benefit' is not developed at all in the SCM agreement, seemingly as a result of the disagreement of the negotiating parties, some seeking to refer to commercial benchmarks, others to the cost to the subsidising government, others to the recipients of the subsidy. [282] This can be contrasted with the 'financial contribution' requirement which, albeit not fully unambiguous and exhaustive, is highly elaborated. Although important issues, such as the cost to government, could not be solved during the negotiations, it was not difficult to codify with a certain degree of precision the forms of financial contribution that were regarded as subsidy already in the GATT. [283]

Article 87(1) EC generally prohibits 'any aid' which 'favours' certain undertakings or the production of certain goods. Like the SCM, the EC Treaty does define what an 'aid' – and, in particular, the advantage inherent in it – is. Nor a definition can be found in the previous, and now expired, ECSC Treaty.

A simple, and at the same time general, explanation has already been suggested in the previous chapter. These two treaties of the 1950s share the same reticence, and immaturity, with respect to the definition of public subsidies that can be found in the context of the GATT, signed only a few years earlier. This silence not only concerned the forms of action that should be regarded as a subsidy or an aid but inevitably affected what is certainly the *central* – and at the same time the *most elusive* - element of the definition, the *advantage*.

When the legislator is silent, it is often for the administrative and judicial bodies, which are called to apply the rules, to provide some clarification. The *market* has consistently been referred to as the standard to test the public activity in the market, thus becoming, despite difficulties and criticisms which we are about to examine, a true *paradigm* in the advantage analysis.

Before giving some comments, some examples of this recognition may be provided.

We may commence with the GATT. In the early 1980s, the US and the EC were confronted in the so-called 'steel cases'. Although the GATT dispute settlement was never involved, this controversy sparked for the first time a serious debate on

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[282] Low (2001: 114-115).
[283] Cf, for example, the examples of domestic subsidies in Article 11(3) of the Tokyo Subsidy Code.

*inter alia* the application of 'commercial considerations' to establish whether various forms of financial assistance into State-owned enterprises constituted a countervailable subsidy.[284] Second example. Just a few months before the advent of the WTO, a Panel report was issued in the *Carbon Steel I* dispute. This report was never adopted but contains many significant findings which reaffirm the soundness of the use of commercial criteria to test various forms of public economic activity.

We have to wait the WTO for the first sweeping formulation of the market as a general standard. In *Canada – Aircraft*, both the Panel and the Appellate Body referred to the market as the 'only logical basis' and 'an appropriate basis for comparison' to establish the benefit. The Appellate Body noted that

> the marketplace provides an appropriate basis for comparison in determining whether a 'benefit' has been 'conferred', because the trade-distorting potential of a 'financial contribution' can be identified by determining *whether the recipient has received a 'financial contribution' on terms more favourable than those available to the recipient in the market.*[285]

Numerous findings of the Court of Justice echo this definition. In one of the most quoted we can read:

> in order to determine whether a State measure constitutes aid, it is necessary to establish *whether the recipient receives an economic advantage which it would not have obtained under normal market conditions.*[286]

As has certainly not passed unnoticed to the attentive reader, the added emphasis in the two passages shows the striking similarity, or virtual identity, of the language of the two courts.

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[284] See Barshefsky, Mattice & Martin (1983); Dominick (1984); Benyon & Bourgeois (1984); Hufbauer & Shelton-Erb (1984: 100 - 102); Bourgeois (1991: passim).
[285] Paragraph 157 (emphasis added).
[286] Case C-39/94 *SFEI*, paragraph 60 (emphasis added).

**First comments**

Conceptually, the reference to the market is no more than the application of the more general and core paradigm of the advantage analysis, ie that the advantage should result from a *derogation from the norm*. In the case of economic activity, the *norm* is represented by the market.

Obviously, findings whereby the market is the 'only logical basis' or 'an appropriate basis for comparison' can however be correct only with respect to the economic activity of governments. Borrowing from the second Opinion of Advocate General Léger in the famous *Altmark* case,

> it appears ... that in the field of State aid the Court distinguishes between two categories of situation: those where the intervention of the State is of economic nature and those where it forms part of the exercise of public power. [287]

Different criteria - *economic* or *normative* - apply to the two different types of conduct and the derogation test accordingly takes different shapes in both legal systems.

More interestingly, if the market should be the norm in the field of economic activities, the Appellate Body's express reliance on the 'trade-distorting potential' of the financial contribution as *the* justification for the use of market benchmarks seems to reveal that the assessment should be based only on those *economic* considerations that may indicate distortions to the competitive process. Reformulating this thought, if a measure deviates from the market, this clearly suggests a potential of distortion of the market.

The further implication might be that, inasmuch as the distorting impact of the subsidy remains (better: the 'potential' as the Appellate Body merely stated), the role to be played at this stage by any public policy objectives pursued by the measure might be quite limited. This for now only tentative conclusion is of crucial importance for the construction of the advantage analysis, and more generally of the regulation of subsidies and State aids. It will therefore be thoroughly addressed in the analysis of both WTO and EC law.

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[287] Paragraph 20.

Finally, the notion of market, as such, still remains a general principle. In order to be fully operative, it needs to be developed into precise benchmarks, applicable to the various forms of economic activity carried out in the market. This is the focus of the next paragraph, and it is at this level that the market paradigm begins to show *all its complexity*.

## Market benchmarks: complex decisions, difficult reviews

### Two-fold complexity

As the conduct in the market can be varied (eg equity and debt financing, guarantees, purchase or sale transactions) so are the benchmarks which define whether that conduct is commercially sound.

Despite this diversity, two variables stand out as crucial in any business decisions: i) the *risk* of the investment and ii) the expected *remuneration for* that risk. The complexity of these decisions and of their subsequent scrutiny can be understood at two different levels, one objective and one subjective.

On the one hand, the key variables of risk and remuneration are significantly affected by many other factors and by the various circumstances of the transaction at hand. Further, information may be scarce, time limited and the context may change, and quickly. As a result, businessmen have to make difficult economic, financial and managerial assessments in a complex and dynamic (in a word: competitive) environment.

On the other hand, although sophisticated technical tools are increasingly developed to make sense of this objective complexity, ultimately the decision making process cannot be solely described as objective and rational. The subjective, one could say human, factor plays a significant role. Eventually, most depends on the personal judgment of the entrepreneur which is based on his/her intuition and experience. Without necessarily adhering to the radical criticism examined in the last section, clearly business is far from being an exact science [or a science at all] and its decisions naturally require a good element of not fully ponderable discretion.

**Regulatory inadequacy**

The complexity of business decisions cannot be fully captured by the rules setting forth the relevant benchmarks.

This is not just a matter of inadequate drafting. The problem is more radical and depends on the fact that the process underlying commercial decisions itself is so multifaceted that virtually any criterion – irrespective of its precision - can become really meaningful *only* when it is applied in practice. In other words, the proposition is that the starting point is certainly given by good, precise and clear criteria, which should take into account of sound indicators, but that eventually only a case-by-case analysis allows determining whether the actual decision is commercially sound. The Commission seems to have been aware of this flexibility when it underlined in its guidelines that various financial and economic factors have to be analysed and balanced to determine whether the contribution is commercially sound. [288]

A good example of this inherent regulatory limit can be found in Article 14 SCM which provides guidelines to calculate the amount of the subsidy in the context of countervailing duty procedures and which, by underlining the circumstances under which a given form of governmental action 'shall not be considered as *conferring* a benefit' (emphasis added), can clearly be used as relevant context for the interpretation of the term 'benefit' under Article 1.1(b) SCM as well. [289] These guidelines refer to concepts such as 'usual investment practice', difference between amounts actually paid and payable on the market, 'adequate remuneration'. In their generality, they are not able to capture the complexity of business decisions. Though correct, they can only represent the beginning of the analysis.

Another example. To say that the expected remuneration for a capital injection into a company is defined by the rate of return on equity [290] is certainly more precise but, again, it cannot hide that what is required in the instant case is the determination of the actual rate which is a complex exercise involving complex

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[288] 1993 Communication, paragraph 37.

[289] See, for example, Panel, *Canada – Aircraft*, paragraph 9.113, Appellate Body, *id*, paragraphs 155 to 158. Cf also Didier (1999:220, footnote 33).

[290] Panel, *Canada - Aircraft*, paragraph 9.165. In the EC see, for example, the 1984 Communication, paragraph 3.3, and the 1993 Communication, paragraphs 35, 43 and 44. See also Case T-296/97 *Alitalia*.

economic, financial and managerial assessments and, as said, involving an ineluctable element of discretion.

## Decisions and reviews

These brief remarks have quite probably already disclosed that the writer's purpose is not to provide a detailed analysis of the application of the various market benchmarks and of the quite often highly technical tools that are used in market analysis, but rather i) to highlight the degree of *complexity* of commercial *decisions* and ii) the *difficulty* of their *review* by administrative and judicial bodies.

In this regard, it should not be forgotten that what is at issue in most of the cases is the review by an administrative or judicial body of an investment decision that a public body has taken, or wishes to take. Now, the complexity of business decisions is inevitably reflected into their review making it a particularly difficult task. The role of the examining body is certainly to check whether the decision at issue is commercially sound. However, the two-fold (objective/subjective) complexity set forth above should be duly taken into account.

On the one side, it is commonly accepted that any review should be based only on the information that were, or could have been, available to the investor at the moment of the business decision (*ex ante* assessment). The premiss is that the commercial environment is dynamic and that the success or failure of the venture may well depend on changes of the circumstances which were unpredictable when the decision was made.

On the other side, it should be repeated that business decisions are not *calculations* but *judgments*. It has been seen that they naturally imply a degree of discretion. This reality should necessarily be taken into account by the examining body which should resist the temptation of substituting the public body's business judgments with its own. In other words, if administrative or judicial bodies should certainly be controllers, they cannot pretend to be entrepreneurs.

## Examples of complexity of market benchmarks

Before focussing on two case-studies which attempt to explain the interplay between public intervention in the economy and the identification of the appropriate benchmark, the following paragraphs briefly discuss some examples of difficulty of application of market benchmarks. In so doing they particularly draw on the abundant indications offered by the EC case-law whose validity may well be extended to WTO law.

### *Diversity of investment objectives*

There are different types of investors and the circumstances of the investment may change. In a word, investment objectives may be disparate and may vary. As a result, the two key variables of risk and remuneration indicated above may be perceived differently in the various cases.

One of the most apparent distinction is that between ordinary investors, which aim at realizing a profit in the relatively short term, and holding companies or groups of undertakings, which pursue a 'structural policy' and are generally 'guided by prospects of profitability in the longer term'. [291] Koenig and Bartosch (2000: 383) further noted that equity investment should be distinguished from debt financing because only the former involves the direct participation in the business. The application of market benchmarks to capital injections may thus be particularly complex since the 'value of the investment' is much more 'dependent on the personal goals of the investor'.

The existence of a vested interest in the undertaking is another notable factor which has an impact on the evaluation of risk and remuneration. The fact that the investor is *already* a shareholder, a lender or a guarantor of the undertaking makes its situation completely different from that of one that does not have any interest in the relevant company yet and is still considering whether to invest in it.

This becomes particularly clear when the company is in difficulties. The 'owner' of the company may accept a lower return when this is necessary to preserve its

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[291] *Alfa Romeo*, paragraphs 19 and 20.

investment. It may even consider *covering the losses* of its subsidiary for a limited period in order to enable it either to reorganise and become profitable again or to close down under the best possible conditions, [292] or to minimise the costs which it might incurred as guarantor and sole shareholder or a higher liability. [293] To anticipate a higher liability an investor may even decide to make a *fresh investment.* [294]

How investment objectives can change according to the circumstances is nicely illustrated by the example of loans. There is a fundamental difference between the case where the loan is *negotiated and granted* and the case where, after the loan relationship has been entered into, the *debtor is in default.* In the former, the investor is motivated by profit. Things *may* change however when the contractual relationship is already in place. The borrower may not pay or, more significantly, *cannot* pay.

The default of the borrower usually triggers the application of penalties or interests higher than those normally due. The creditor's goal is *still* to make a profit out of the transaction. However, if the debtor is in difficulty and is not able to cope with the payments originally agreed, the investment objective changes. It is no more to get a profit but to avoid a loss or at least to recover part of the credit. [295] The debt may need to be rescheduled and the interest charged may be different (usually lower) than that agreed when the loan was initially granted. Similarly, the acceptance to reduce debts of a company in difficulty may be economically justified, in particular when, in the event of insolvency of the debtor, the creditor's loss would be considerably higher. [296]

Two remarks to conclude this paragraph.

From the perspective of the review of the investment decisions, on the assumption that economic actors usually behave similarly in comparable situations, the consideration of what other investors do in the transaction at hand may be relevant. Thus, even making allowance for the discretion underlying any business judgment,

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[292] Case C-303/88 *ENI-Lanerossi*, paragraph 21.
[293] Case T-323/99 *INMA*, paragraph 100.
[294] For an interesting example see Case T-98/00 *Linde*.
[295] Case C-342/96 *Tubacex*, paragraphs 48 and 49; Case C-246/97 *DMT*, paragraphs 24 and 25. See the discussion on the 'regulation of debt' below.
[296] Case T-123/97 *Salomon* v *Commission*, paragraph 68. Cf also *Twenty-Seventh Report of Competition Policy* (1997), page 237; *Thirtieth Report on Competition Policy* (2000) 313.

the participation of other (particularly private) investors in the operation may indicate its commercial soundness, in particular if their contribution is on equal terms and of real economic significance.[297]

The second comment focuses on a crucial point but is limited to flagging an issue which is dealt with exhaustively below. The issue is whether private investors may be motivated also by considerations that are not strictly economic (such as employment or regional development) and, if so, to what extent. This issue is of particular importance because public investors should by definition pursue public interest objectives. It is thus important to understand what role, if any, is played by this consideration at the level of the advantage analysis.

***Restructuring of companies in difficulties and investment of large sums***

Parish (2003: 71) underlines how two cases pose particular problems when it comes to make a business decision to provide financing and to subsequently assess it. In these cases the evaluation of the risk of the investment and of its remuneration may be especially difficult.

The first concerns the financing of loss-making companies in difficulties. We have already seen the impact that a situation of difficulty may have on investment objectives when the investor has a vested interest in the company. This paragraph builds up on those considerations, but focuses on the more specific problem of investments aimed at the *restructuring* of a company in difficulty.

Two issues need to be addressed in the assessment of these cases. The first is whether the support is really aimed at restructuring the undertaking, or whether it merely represents a means to keep an ailing and unprofitable undertaking alive. The answer depends on the assessment of the numerous conditions of the restructuring (such as the economic, financial and managerial situation of the company and the market, the soundness of the restructuring plan, etc). This is a very difficult assessment. The various elements to evaluate and balance in order to reach a decision are several and may be judged differently by investors.

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[297] Didier (1999: 225). By contrast investment decisions of *employees* may not be significant as they may be motivated more by the desire to ensure the survival of their jobs than by prospects of profitability of the

Another case where it is particularly difficult to determine whether a private investor would have stepped in is when large sums of money are involved. This may occur (again) when the restructuring of big groups is involved. The fact that the financial resources necessary for the restructuring may be considerable is a further element that adds to the difficulty of an already difficult assessment. A case where the 'money' factor comes into special relevance is when it is necessary to build big infrastructures, such as extensive networks. This case, which raises interesting issues concerning the advantage analysis, is thoroughly discussed below.

***Ambivalence of market indicators***

Market indicators, such as price and quantity, are not always reliable, particularly if considered separately. The assessment of whether we have a normal commercial transaction requires the consideration of all the relevant factors.

Normally, the procedure followed for the sale is important to establish whether the transaction is commercially sound.

The price resulting from the *sale* through an open and transparent tender procedure to the highest bidder will generally be held to be the market price. Although in a different factual setting, the celebrated *Almark* case has provided a powerful confirmation of the importance of procedures, such as public procurement, to exclude the existence of an advantage. [298] Crucially, the government here was not *selling* but *buying*. As Hansen, Van Ysendyck and Zühlke (2004: note 16, page 204) cleverly noted, the test here is not about *profit* but *efficiency*. This does not detract that the rationale – the *transaction process* has a fundamental impact in determining that the *price* is commercially sound - is the same.

The case is similar with respect to shares or other securities traded on the stock exchange. The market price is the price at which the relevant shares or securities are traded (ie sold at the price determined by the cumulative demand of buyers).

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company: see Case T-296/97 *Alitalia*, paragraph 83.

[298] See Case C-280/00, paragraph 95. See also the Opinion of Advocate General Jacobs in Case C-126/01 *GEMO*, paragraph 119.

An alternative procedure, for example with goods like land or building, may be the evaluation by an independent expert. [299]

Nevertheless, this is not the end of the story. The payment of the market price, even though following a certain procedure which guarantees it is the result of market forces, may not be enough to exclude that the transaction is not commercial. An analysis of the EC case-law is particular useful in this regard.

The first warning arrived in the *Bremer Vulkan* case where the Court underlined that sometimes considering the stock market price, without adequate explanation, as the sole determining factor of the value of shares may be 'too formal, rigid and restrictive'. [300] In other words, to rely only on one market indicator, and an important one such as the price, may not be enough, if the context demands a more complex analysis. The advantage may be conferred by other circumstances of the case.

A good illustration thereof was given in two recent decisions of the Court of Justice. In the *BAI* and *P&O European Ferries* cases the issue was whether the conclusion by a public authority of an agreement to purchase travel vouchers for ferry travels between Spain and the UK at the market price could be regarded as a State aid. Contrary to the Commission, the Court of First Instance found that this was the case. In particular, the Court made it clear that

> ... the mere fact that a Member State purchases goods and services on market conditions is not sufficient for that transaction to constitute a commercial transaction concluded under conditions which a private investor would have accepted, or in other words a normal commercial transaction, if it turns out that the State did not have an actual need for those goods and services. [301]

In other words, it seems that variables such as *price* and even *quantity* may not be fully significant if the actual decision to purchase goods or services from the market does not correspond to a *real and actual need* of the buyer. In these cases, the result

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[299] Cf the 1997 Commission Communication on the sale of land and building.
[300] For another interesting example, see Joined Cases C-329/93, C-62/95 and C-63/95 *Bremer Vulkan*, paragraph 36.

would be the grant of a clear *out-of-the market* advantage to the supplier that would be able to dispose of goods or services which, according to commercial consideration, would not have been placed, particularly when large amounts are involved.

This case law seems to be correct. Most importantly, it seems to remind us the complexity of market transactions. The advantage analysis of economic activity must be a comprehensive one which takes into account all relevant factors, among which the market price is an important although not an exclusive one.

What are the implications of this case law? In *BAI* and *P&O* the public authority bought the services directly from the provider. The price was the normal market one. It was not determined through a special competitive procedure such an auction. Arguably, however this jurisprudence may have an impact also on those cases where the price of the good or service for which there is not a real need is determined by a stock market or through a tender process. In other words, the BAI/P&O decisions highlight that what is important is not the procedure followed to determine the price of the good/service at issue but whether a private operator would have bought (that quantity of) that good/service in the first place.

The ambivalence of certain market indicators, and in particular prices, becomes apparent in the next section when an additional element of complexity - the public intervention in the economy - is considered.

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[301] Joined Cases T-116/01 and T-118/01 *P&O*, paragraph 117; see also Case T-14/96 *BAI*, paragraph 74 et seq.

## 2. The critical interplay between public intervention in the economy and market

The previous section has shown the complexity inherent in commercial decisions and in their assessment. This section analyses a further possible element of complexity in the advantage analysis of economic activity which is given by the *public intervention in the economy*, expression which generally refers to *any* public conduct – be it economic or not - that may have an impact on the market. Two case-studies, which emphasise different perspectives, are examined.

### The impact of the public intervention in the economy on market analysis

### (case study 1)

Four WTO disputes are particularly significant in analysing the impact that the public intervention in the economy in its various forms may have on the identification of the appropriate market benchmark. The analysis touches both the SCM Agreement and the Agreement on Agriculture. The brief exposition of the main arguments and findings in the various disputes is followed by some comments.

#### *Canada - Dairy (Article 21(5) I)*: the impact of regulation

The first case is *Canada - Dairy (Article 21(5) I)*. It should be immediately said that what was under examination was not the notion of 'benefit' under Article 1.1(b) SCM, but the definition of 'payments' in Article 9.1(c) AoA. Drawing from the definition of subsidy in the SCM Agreement as relevant context, the Appellate Body however confirmed that the notion of 'payment' is meaningful only through a comparison with a *market benchmark*. [302]

Two findings emerge as particularly significant for our analysis.

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[302] *Canada – Dairy (Article 21(5) I)*, paragraph 87; *US – FSC*, paragraph 136.

First, the Appellate Body noted that it was not correct to consider the *domestic* price, fixed by the government in the context of a *heavily regulated market*, as a proper benchmark for determining whether the lower price of milk to processors for *export* represented an advantage. Secondly, in a clear exposition of micro-economics fundamentals, the Appellate Body indicated that the price is not the only useful market indicator. In its words,

> [a]lthough the proceeds from sales at domestic or world market prices represent two possible measures of the value of milk to the producers, we do not see these as the only possible measures of this value. For any economic operator, the production of goods or services involves an investment of economic resources. In the case of a milk producer, production requires and investment in fixed assets, such as land, cattle and milking facilities, and an outlay to meet variable costs, such as labour, animal feed and health-care, power and administration. These fixed and variable costs are the total amount which the producer must spend in order to produce the milk and the total amount it must recoup, in the long-term, to avoid making losses. To the extent that the producer charges prices that do not recoup the total cost of production, over time, it sustains a loss which must be financed from some other source, possibly 'by virtue of governmental action'. [303]

In a nutshell, the impact of the public intervention in the domestic market (in the form of heavy regulation) made the reference to the prices prevailing therein not reliable for the analysis in the export market. The use of another market benchmark, the costs of production, was therefore necessary.

### *US – Carbon Steel II* and *US - Countervailing Measures*: the impact of the 'design of economic and other policies'

The issue of the impact of public intervention in the market, and of the significance of prices derived therefrom, came out again in the *US – Carbon Steel II* and *US - Certain Measures* disputes with respect to privatisations.

In *US - Certain Measures* the US had imposed countervailing duties on imports from privatised companies alleging that the benefit of the subsidies granted prior to

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[303] Appellate Body, *Canada - Dairy (Article 21(5) I)*, paragraph 87.

privatisations had 'passed through'. One of the legal issues was whether the payment of a fair market value for the company, in the context of an arm's length transaction and in compliance with commercial considerations, exhausted the benefit of subsidies previously received by the company. [304]

The same question arose in a previous dispute, *US – Carbon Steel II* where the Appellate Body upheld the Panel's conclusion that this was the case but significantly restricted its ruling to 'the particular circumstances of the case' and to 'the facts of the case'. [305] It is only in the *US - Certain Measures* dispute, however, that the Appellate Body more vigorously *qualified* the Panel's finding that privatisations at arm's length and for fair market value *always exclude* that the benefit is passed through.

The crucial factor was the ability of governments to direct the conditions of the process of privatisation, and in particular to influence the sale price, with the result that the latter cannot be considered the outcome of a genuine market process. The Appellate Body held that privatisations at arm's length *may* result in extinguishing a previously conferred benefit but this is *not necessarily* so. In the words of the Geneva-based body,

> the Panel's absolute rule of 'no benefit' may be defensible in the context of transactions between two private parties taking place in reasonably competitive markets; however, it overlooks the ability of governments to obtain certain results from markets by shaping the circumstances and conditions in which markets operate. Privatizations involve complex and long-term investments in which the seller - namely the government - is not necessarily always a passive price taker and, consequently, the 'fair market price' of a state-owned enterprise is not necessarily always unrelated to government action. In privatizations, governments have the ability, by designing economic and other policies, to influence the circumstances and conditions of the sale so as to obtain a certain market valuation of the enterprise. [306]

The conclusion was therefore that what is not consistent with WTO law is an irrebuttable presumption that privatisations at arm's length and for fair market

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[304] This issue is also analysed from the perspective of the identification of the *beneficiaries* of the subsidy in the next chapter.
[305] Paragraph 74.

value exhaust the benefit. This may be so, and indeed there is a *rebuttable* presumption that a benefit ceases to exist after privatisations at those conditions. Nevertheless, as this is not always the case, investigating authorities should always carry out a *case-by-case* assessment. [307]

The crucial finding coming out of these two disputes, which is in line with *Canada – Dairy (Article 21(5) I)*, is that prices produced by markets are not always indicative of a genuine market process, particularly when there is a significant public intervention in the economy, in the case at hand in the form of 'design of economic and other policies'.

### *US - Softwood Lumber IV*: the impact of commercial presence

What was at issue in the *US - Softwood Lumber IV* dispute was again the definition of the appropriate market benchmark following a significant commercial presence of the government in the market. The case is also interesting because – at a more general level - it gave the opportunity to clarify the important concepts of 'market' and 'prevailing market conditions'. [308]

Considering these two specificities - significant commercial presence and definition of the market concept - the arguments and the findings of this dispute deserve an extended examination.

The case concerned countervailing duties imposed by the United States against imports of certain softwood lumber products from Canada. The practice under examination was the conferral by Canada of the right to harvest timber in Crown Land. This practice was found to constitute a financial contribution in the form of provision of goods (under Article 1.1(a)(1)(iii) SCM) to lumber producers. [309]

The issue which is of interest for our analysis was whether these goods were also provided at less than adequate remuneration thereby conferring a benefit pursuant to Article 14(d) SCM.

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[306] Appellate Body, *US - Certain Measures*, paragraph 124.
[307] Ibid, paragraph 127.
[308] See Trebilcock & Howse (2005: 268).
[309] Panel, *US - Softwood Lumber IV*, paragraphs 7.9 to 7.30; Appellate Body, *US - Softwood Lumber IV*, paragraphs 46 to 76.

It is known that the problem of the proper pricing of natural resources is not new. For example, Hufbauer & Shelton Erb (1984: 95 to 99) cites three US countervailing duty cases of the beginning of the 1980s concerning crude petroleum, natural gas and (again) lumber. The authors intriguingly distinguished between non-transportable and transportable natural resources, concluding that the provision of non-transportable natural resources should not be subject to international scrutiny for the lack of a 'ready standard' (such as a world-wide or national price) to use as a benchmark. Whatever merits this distinction and conclusion may have, lumber is clearly transportable. A benchmark, and a market one, should be found.

Returning to the dispute under examination, in its determination the United States Department of Commerce (USDOC) found that the prices of private timber sales in Canada did not represent a commercial market because they were distorted by government intervention. The supply of lumber originating in Crown Land was so dominant in the market that the prices of the few private supplies were not determined independently and were necessarily depressed and aligned to the lower level of governmental prices. The USDOC therefore used as a benchmark prices of stumpage in certain bordering states in the northern United States, making adjustments to account for differences in conditions between those states and Canadian provinces.

The Dispute Settlement Organs had to determine whether the United States' practice was consistent with Article 14(d) SCM which requires that the adequacy of the remuneration in the provision of goods should be determined

> in relation to prevailing market conditions for the good or service in question in the country of provision or purchase (including price, quality, availability, marketability, transportation and other conditions of purchase or sale).

The main point of disagreement between the United States and Canada concerned whether it was permissible under that provision for an investigating authority to use a benchmark *other than* private *prices in the country of provision*.

To address this issue, which technically revolved around the interpretation of the phrase 'in relation to', [310] both the Panel and the Appellate Body made interesting findings with respect to the concepts of market and market conditions under Article 14(d) SCM.

The Panel found that 'prevailing market conditions' refer to the market conditions 'as they exist' or 'which are predominant' in the country of provision. [311] Thus, the United States' argument that the term 'market' means 'fair market value' or market 'undistorted by government intervention' was rejected. [312] In particular, the Panel underlined that

> as long as there are prices determined by independent operators following the principle of supply and demand, *even if supply or demand are affected by the government's presence in the market*, there is a 'market' in the sense of Article 14(d) [of the] SCM Agreement' [313]

Although conceding that the United States' approach, whereby the term 'market conditions' would necessarily imply a market undistorted by the government's financial contribution, was going too far, the Appellate Body underlined that the Panel's interpretation was 'overtly restrictive' and that, in some cases, the prices of the country of provision may not be informative.

The Panel itself had provided two examples of situations where it may not be possible to use in-country prices: where the government is the only supplier of the goods, and where the government administratively controls prices. The Appellate Body did not see any significant difference between the two situations:

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[310] Contrary to the Panel, the Appellate Body construed the expression 'in relation to' in Article 14(d) as not necessarily meaning 'in comparison with' but rather 'as regards' and 'with respect to'. Consequently, although prices of similar goods sold by private suppliers in the country of provision should represent the starting point and the primary benchmark, they are not the exclusive benchmark if certain conditions make them unreliable.

[311] Panel, ibid, paragraph 7.50.

[312] ibid, paragraphs 7.50 to 7.51.

[313] ibid, paragraph 7.60 (emphasis added). On the facts of the case, the Panel concluded that the resort to US prices as the benchmark for the determination of benefit on grounds that private prices in Canada were distorted was inconsistent with Article 14(d) SCM (ibid, paragraph 7.64).

> [i]n terms of market distortion and effect on prices, there may be little difference between [those situations]. Whenever the government is the predominant provider of certain goods, even if not the sole provider, *it is likely that it can affect through its own pricing strategy the prices of private providers for those goods*, inducing the latter to align their prices to the point where there may be little difference, if any, between the government price and the private price. [314]

As regards the benchmarks alternative to private prices in the country of provision, these should always relate or refer to or be connected with the prevailing market conditions in the country of provision and accepted that these could include 'proxies that take into account prices for similar goods quoted on world markets' or 'proxies constructed on the basis of production costs'. [315]

**Comments on the case-study**

The teachings of the case-study are numerous and significant.

First, governments intervene in the economy and do so in various ways and for many reasons. The case-study has shown the variety underlying the expression 'public intervention in the economy'. Governments may regulate markets (*Canada - Dairy (Article 21(5) I)*), they may 'design economic and other policies' (*US – Carbon Steel* and *US – Certain Measures*), a formulation which is capable to include both economic activity and the exercise of public powers, and finally they can provide goods in the market in competition with private suppliers (*US - Softwood Lumber IV*).

Secondly, the government is an important agent and its conduct may affect, sometimes substantially, the market functioning. This may be particularly clear when it exercises public powers, such as when it tightly regulates a market (*Canada - Dairy (Article 21(5) I)*). This can equally be true when it acts commercially and enjoys a dominant position in the relevant market thus enabling it to dictate a certain price level (*US - Softwood Lumber IV*).

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[314] Paragraph 100 (emphasis added).

[315] In the light of the findings of the Appellate Body, it seems that the express reference to the 'country of provision or purchase' in Article 14(d) (and also in Article 14(a)) is in fact superfluous. It seems indeed natural that the starting point of *all* benefit determinations under Article 1.1(b) and/or Article 14 SCM is necessarily the market where the *government* and the *recipient* operate.

Thirdly, the importance of the public intervention in the market can put into question the concept of market itself, one of the most important paradigms of the advantage analysis. The *US – Lumber IV* provides an interesting debate in this regard. The Appellate Body's sensible final word is that the existence of a market, and hence the possibility of deriving benchmarks from it, does not necessarily require *an utopian place free from any form of external intervention by the public hand.* In order to achieve certain results in the public interest, governments have to intervene in the economy.

However, and we come to the fourth important discovery, since the public intervention in the economy may be significant and affect the working of market forces and market outcomes, the advantage analysis may become difficult. The identification and application of the appropriate benchmarks may be demanding. As the Appellate Body indicated, adjustments may be needed, 'proxies' may be resorted to. In some cases, the most common market benchmarks, such as prices, may lose their significance altogether and the reference to other commercial indicators, such as costs, may be required (see *Canada - Dairy (Article 21(5) I)* and *US - Softwood Lumber IV*).

It may finally be underlined that the use of costs as appropriate commercial references is sound and is not novel. It is sound because, along prices and revenue, costs are among the basis factors taken into account by firms in their production decisions. Its use is consequently not new in the field of anti-dumping, [316] of competition law, [317] and, as the coda to this chapter on the compensation of public services shows, also in the area of State aid/subsidy law.

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[316] Van Bael, I and Bellis, JF (2004).

[317] The much debated area of pricing abuses, particularly predation, constantly refers to costs as relevant benchmarks. For EC and UK law see Whish (2003); for US law see Hylton (2003).

## The expansion of market logic and the redefinition of the public intervention in the economy: the example of infrastructure

## (case study 2)

The previous WTO case-study demonstrates the difficulties to determine the appropriate benchmarks when the market is significantly affected by the *public intervention in the economy.* Similar issues emerge in the EC *La Poste* saga where the government provided a national postal network to guarantee a public service.

Using the example of infrastructures, this case-study has two aims: first, to confirm the special difficulties caused by the public intervention in the economy, and, secondly, to highlight the current trend of market liberalization, the extension of market logic to areas which were previously sheltered from it, and the consequent redefinition of the public role in the economy.

### The *La Poste* saga: the impact of a public 'natural monopoly'

Before analysing the Court of First Instance (2000) and the Court of Justice (2003) decisions, it is useful to briefly explain the background.

*La Poste* operates as a legal monopoly the ordinary mail service in France. It is further authorised by law to perform certain activities open to competition, and in particular express delivery services which are carried out by its subsidiaries, *Société Française de Messagerie International* (SFMI) and *Chronopost* (hereinafter *SFMI-Chronopost*).

The crucial legal and economic issue in the saga was whether the logistical and commercial assistance provided by *La Poste* to *SFMI/Chronopost* was in accordance with market conditions. Called to give a preliminary ruling in *SFEI*, the Court noted that

> [i]n order to determine whether a State measure constitutes aid, it is necessary to establish whether the recipient undertaking receives an economic advantage which it would not have obtained *under normal market conditions*.

In examining that question, it is for the national court to determine what normal remuneration for the services in question is. Such a determination presupposes an economic analysis taking into account *all the factors which an undertaking acting under normal market conditions should have taken into consideration when fixing the remuneration for the services provided.*

In the light of the foregoing considerations, the answer to the first question must be that the provision of logistical and commercial assistance by a public undertaking to its subsidiaries, which are governed by private law and carry on an activity open to free competition, is capable of constituting State aid within the meaning of Article [87 EC] if the remuneration received in return is less than that which would have been demanded under normal market conditions. [318]

A few months after the preliminary ruling delivered in 1996, the Commission adopted a decision and concluded that the logistical and commercial assistance provided by *La Poste* to its subsidiary did not constitute State aid because it corresponded to normal business conditions since it covered the *full-cost prices* (total costs plus a mark-up to remunerate equity capital investment).

The Court of First Instance [319] reviewed the Commission decision and found that its economic analysis was not consistent with the guidelines laid down by the Court in *SFEI.* The mere verification of the reimbursement of costs was not sufficient. In particular, even supposing that those costs were fully covered, could not exclude that any aid had in fact been granted, considering that *La Poste,* by virtue of its position of monopolist in the reserved sector, could have provided the services at lower cost than a private undertaking not enjoying those rights. The CFI concluded that the correct benchmark was the remuneration that would have been demanded by a private investor *not operating in a reserved sector.* [320]

The CFI's decision was appealed before the Court of Justice. The significance of the Court's reasoning deserves an extensive quotation. [321] For the reader's convenience, the main passages have been emphasised.

The Court begins by repeating the main legal point laid down by the CFI:

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318 Case C-39/94 *SFEI*, paragraphs 59 to 61 (emphasis added). Building up on the market economy investor principle, Advocate General Jacobs was more precise in the indication of the various factors to consider (see paragraph 61 of the Opinion).
319 Case T-613/97 *UFEX*, paragraph 64 et seq.
320 Ibid, paragraph 75.
321 Joined Cases C-83/01P, C-93/01P and C-94/01P, *Chronopost*, paragraphs 31 to 40.

... the appellants allege that the Court of First Instance infringed Article [87(1) EC], by giving an incorrect interpretation of the concept of normal market conditions used in the *SFEI* judgment.

In that regard, the Court of First Instance stated ... that the Commission should at least have checked that the *payment* received by La Poste was *comparable* to that demanded by a *private* holding company or a *private* group of undertakings *not operating in a reserved sector.*

The following of the reasoning is devoted to the criticism of this premiss

> That assessment, which fails to take account of the fact that an undertaking such as La Poste is in a *situation* which is *very different from that of a private undertaking acting under normal market conditions*, is flawed in law.
>
> La Poste is *entrusted with a service of general economic interest* within the meaning of [Article 86(2) EC] ... Such a service essentially consists in the obligation to collect, carry and deliver mail for the benefit of all users throughout the territory of the Member State concerned, at uniform tariffs and on similar conditions as to quality.
>
> *To that end, La Poste had to acquire, or was afforded, substantial infrastructures and resources (the postal network), enabling it to provide the basic postal service to all users, even in sparsely populated areas where the tariffs did not cover the cost of providing the service in question.*
>
> Because of the characteristics of the service which the La Poste network must be able to ensure, *the creation and maintenance of that network are not in line with a purely commercial approach.* ... Ufex and Others [ie the appellants] have indeed accepted that a network such as that available to SFMI-Chronopost is *clearly not a market network. Therefore that network would never have been created by a private undertaking.*
>
> Moreover, the provision of logistical and commercial assistance is inseparably linked to the La Poste network, since it consists precisely in making available that *network which has no equivalent on the market.*

The conclusion of the Court offers the proper interpretation of 'normal market condition' in the instant case.

> Accordingly, *in the absence of any possibility of comparing the situation of La Poste with that of a private group of undertakings not operating in a reserved sector, normal market conditions, which are necessarily hypothetical, must be assessed by reference to the objective and verifiable elements which are available.*

In the present case, the *costs* borne by La Poste in respect of the provision to its subsidiary of logistical and commercial assistance can constitute such *objective and verifiable elements.*

On that basis, there is no question of State aid to SFMI-Chronopost if, first, it is established that the price charged properly covers all the additional, variable costs incurred in providing the logistical and commercial assistance, an appropriate contribution to the fixed costs arising from use of the postal network and an adequate return on the capital investment in so far as it is used for SFMI-Chronopost's competitive activity and if, second, there is nothing to suggest that those elements have been underestimated or fixed in an arbitrary fashion.

The case was thus remanded to the Court of First instance for a new decision based on the directions of the Court. [322]

## Comments on *La Poste*

Three main issues emerge from the case and induce comments.

### *Incomparables: the singularity of natural monopolies*

Following Advocate General Tizzano, [323] the Court correctly questions the premiss of the reasoning of the Court of First Instance, ie the possibility of comparing the situation of *La Poste* with that of a private group of undertakings, and in particular one not operating in a reserved sector.

The presence of the network, with its 'substantial infrastructures and resources', represents a *unique factor* as well as a *fundamental obstacle* to the possibility of finding any 'equivalent on the market'. This is certainly correct if the industry of ordinary mail is considered as a typical example of *natural monopoly*, that is an industry where only one firm can operate in the market profitably because the latter can support only one network. [324]

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[322] See the recent decision in Case T-613/97.
[323] See paragraphs 38 to 63 of the Opinion.
[324] See the paragraph 'A primer on public, private and publicly provided private goods' in section II for an analysis of natural monopolies and their problem.

The Court, however, also notes that the 'creation and maintenance of that network are not in line with a purely commercial approach' with the result that it is 'clearly not a market network' since 'it would have never been created by a private undertaking'. Although the Court clearly refers to the situation of *La Poste*, for the sake of accuracy, it is worth underlining that, although this reasoning may well be true *on the facts of the case*, it does not necessarily represent a general rule.

In this regard, it may be useful to refer to section 2 of this chapter and to the discussion on public and private goods.

In general, being private goods, postal services could also be carried out be private undertakings.

At least hypothetically, a *postal network* could be created and run profitably by private entrepreneurs. The investment to create a vast national network may be considerable but not necessarily impossible to finance.

What is crucial, however, is the provision of the service, particularly if there are standards and obligations that have to be complied with. We have seen that the issue of the performance of a *universal service obligation* is particularly intricate because, under certain circumstances, some form of public intervention may be required. It has been underlined, however, that this concept is by definition 'dynamic' and liable to change rapidly. Finally, it has also been tentatively argued that, more generally, the provision of *any* public service should be considered as an economic activity.

In conclusion, what does not seem to be justified is to transcend the finding of the Court *on the circumstances of the case* into a formulation of *absolute impossibility* of the private sector to create and maintain the network and provide the relevant (universal) services. Although often some form of public support may be required, the market may generally provide these services.

***'Normal market conditions' and 'objective and verifiable elements'***

After underlining the uniqueness of a natural monopoly, what is still to be answered is how to interpret correctly the 'concept of normal market conditions used in the *SFEI* judgment'. [325]

The Court correctly notes that 'in the absence of any possibility of comparison the situation of *La Poste* with that of a private group of undertakings not operating in a reserved sector, normal market conditions, which are necessarily hypothetical, must be assessed by reference to the objective and verifiable elements which are available'. [326]

The first important observation is that the fact that a comparable market situation cannot be found does not lead the Court to simply reject the reference to 'normal market conditions'. These are simply defined as 'hypothetical'. Admittedly, this term may be misleading, since it may raise the impression that we are not *really* talking of a *market* and its *rules*, which is clearly not the case (albeit monopolistic, there is a market), but this doubt is immediately removed by the following reasoning and conclusion of the Court.

The monopolistic structure of the market makes difficult the use of *normal* market benchmarks, such as prices. As the Advocate General indicated, the *only* possibility to rely on a price would have been the one that could have been obtained if the logistical and commercial services had been put on the market and that private investors would have been prepared to offer, but this eventuality did not occur in the case at hand. [327]

These difficulties do not preclude the reference to the 'objective and verifiable elements which are available' to assess the compliance with *market conditions*. Absent the possibility of referring to prices, the only 'objective and verifiable' commercial benchmark could not but be represented by *costs*.

This reasoning, which immediately calls to mind that of the Appellate Body, particularly in *Canada – Dairy*, is highly persuasive. As Advocate General Tizzano underlines

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[325] Paragraph 31 of the *Chronopost* decision.
[326] Paragraph 38.

> in the absence of adequate information on the market value of the services offered and with no estimates associated with a general group strategy to go on, *an undertaking operating under normal market conditions would be obliged to fix the price of such services on the basis of their costs'*. [328]

Finally, Morgan De Rivery, Le Berre-Doder and Thibault-Liger (2005: 163 et seq) make an important warning about the use of costs.

> First, transparency needs to be ensured. This is achieved through accurate separate accounts for each activity carried out by the undertaking. [329] Secondly, in the specific context of the costs of a public undertaking, there is a risk that 'les coûts de l'opérateur public peuvent être minimisés par l'existence même de ce financement public'. [330]

***Access to infrastructures and use of market benchmarks***

The important teaching of *La Poste* is that, despite the difficulties for the presence of a natural monopoly, the Court still refers to *market benchmarks*.

What underlies the Court's reasoning is the consideration that, once an infrastructure has been created (no matter whether the market would have provided it, or whether it is needed for providing a public service), it should be *run according to market logic*. The access to it - by operators wishing to manage it, service suppliers, and final users - should always be assessed on economic terms, in the *SFEI* jargon 'under normal market conditions'.

In a word, the hiatus between the creation of the infrastructure and its operation is so imperceptible that the whole emphasis is exclusively shifted towards the latter. The discussion about whether the creation of the infrastructure is economic or not becomes essentially otiose (see the 'doubt' below). When the dust of the works is

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[327] Paragraphs 54-55 of the Opinion.
[328] Paragraph 57 of the Opinion (emphasis added).
[329] See in this regard Directive 80/723/EEC – the 'Transparency' Directive – last amended by Directive 2005/81/EC.
[330] This point does not seem to have been taken into account in the remand decision of CFI in *La Poste* (see paragraphs 189-190).

removed what remains is *a facility* which *should be run economically*. The otherwise inevitable conclusion is that an advantage is granted.

Building up on the teachings of the *La Poste* saga the next paragraph attempts to analyse more in depth the relation between infrastructure and market, particularly with respect to the EC law debate.

## The relation between infrastructure and market under State aid rules

### *The traditional approach*

The language of the traditional approach stresses two elements.

First, infrastructures are non-economic, substantially because the private sector would not provide them, and belong to the inherently public prerogatives. Although often unsaid, the certainly thought implication is that they should somewhat be sheltered from the application of State aid law.

The second argument is that infrastructures are normally general, ie available across the board, with the result that they cannot confer any special advantage. The only problem under State aid rules would therefore occur when there is a discriminatory access to infrastructure.

It is worth noting that this argument confuses the various meanings of the term general which is intended more with reference to the *universal subjective application* of the measure rather than with its *normal character*. The debate is thus usually but incorrectly put in the context of the specificity analysis rather than in that of the advantage. This confusion, which continuously recurs in the areas, and the need to distinguish between the two levels of the analysis, is analysed in more detail below

In a word, the result is that, unless specific access is proved, infrastructures are not a problem for State aid law.

### *Market liberalization: market logic expansion and multi-layered analysis*

Santamato and Westerhof (2003: 646) have questioned the force of the two main arguments of the traditional approach to infrastructure under State aid rules, that is

the 'market failure' argument [331] and the 'non-selectivity' argument. [332] It is however the market liberalization process that calls for a review of the old view.

The introductory section has shown the ongoing dramatic change in the economic and political context. The recent decades have seen a process of increasing liberalization of the market.

This tide has involved also infrastructures and the services supplied through them. [333] Increasingly, budgetary constraints and the desire to benefit from the know-how and efficiency of the private sector are increasingly seeing an involvement of the latter in the provision and operation of infrastructures and in the supply of services. Governments do not necessarily leave the field altogether but institute sometimes complex forms of co-operation with the private sector, so called Public Private Partnerships (PPP), where, at least that is the goal, the synergy should deliver more efficiently better services to consumers.

In the field of infrastructure, all this has produced an *expansion of market logic* as well as an *increase of the levels of public/private interaction.* In other words, the current infrastructure debate under State aid law involves activities which are increasingly considered economic and which occur at various levels/markets.

Without entering the details of a complex, and still not settled, area of State aid law, the brief analysis of two examples may be useful to sketch the two main traits of the said phenomena of the rise of market logic and of a multilayered analysis.

The following considerations mainly draw on issues raised by the already mentioned phenomenon of PPP.

If the government decides to fund the construction and/or the management of an infrastructure, in order to exclude any advantage, it has to do so at the (minimum) market price/cost resulting from an open, transparent and non-discriminatory procedure (general principles which are valid beyond the applicability of EC public

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[331] 'Non-excludable [public] goods are not very frequent: for most infrastructure there are technical means of charging a price for the use of the facility'.

[332] 'The presence of mechanisms to avoid discrimination between competitors is certainly capable of significantly reducing the distortion of competition. However, non-selectivity ***within*** a sector does not imply a total absence of potential distortion: the issue of selectivity ***between*** sectors or between territories remains open'.

[333] See, eg, Santamato and Westerhof (2003); Koenig and Kiefer (2005); Koenig and Haratsch (2004).

procurement law). [334] In addition, if the service purchased can be defined as one of general economic interest the conditions laid down by the Court in *Altmark*, which are thoroughly analysed at the end of the chapter, should be fulfilled. If a tender is not possible, market benchmarks should still be applied, in particular by attempting to construe an appropriate consideration. In this regard, even beyond the area of public services, the criteria indicated by the *Altmark* decision, particularly in its third and fourth conditions, could provide useful guidance.

Just to underline the complexity of the involvement of private undertakings in the infrastructure area, Koenig and Haratsch (2004: 396-397) have underlined the possible State aid concerns at the level of the shareholders of the owner/operator of the infrastructure. Apart from a possible privileged access, these may benefit from the distribution of dividends (which should therefore be in line with commercial practice) and from the sale of assets/shares (which may justify the imposition of a temporary ban).

Finally, at the level of the users of the infrastructure/service, it seems that the two main criteria to follow to exclude any advantage are those of an open (ie non-discriminatory) access and, again, of market pricing. Since it may well occur that an infrastructure is used by one or more specific undertakings only, it seems however that the most important criterion is the latter. Accordingly, in line with findings of the Court's *La Poste* decision, any advantage would be excluded if the access to the infrastructure is granted at the (maximum possible) market price. [335]

Another area where both market logic expansion and multi-layered analysis can be seen is airport financing.

Following a shift of focus from the assistance to airlines to that to airport operators, and the controversial *Ryanair* decision which raised the attention to the new phenomenon of low-cost airlines and their natural bases, ie regional airports, in 2005 the Commission adopted new Guidelines on Financing of Airports and Start-Up Aid to Airlines Departing From Regional Airports. [336]

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[334] It may be recalled that the area, which has close connections with State aid law, has recently been subject to a reform (embodied by Directive 18/2004/EC) which was to be implemented by the end of January of 2006.

[335] Koenig and Haratsch (2004: 394).

[336] For a commentary on the guidelines see Bartosch (2005); Soltész (2006).

This piece of soft law confirms the two trends indicated above.

On the one hand, the complexity of infrastructure under State aid rules since different markets have to be considered in order to determine whether there is an aid (for example, not only that of users, particularly airlines, but also that of airport operators).

On the other hand, many activities are increasingly classed as economic and subject to market rules. In this regard, paragraph 59 clearly reads that the guidelines apply to 'all airports activities, with the exception of safety, air traffic control and any other activities for which a Member State is responsible as part of its official powers as a public authority'. Apart from this obvious safe harbour, the remainder of the activities concerning the construction, operation and other airport services are considered economic. Whereas it is not clear whether the new guidelines have revisited the famous statement of the previous guidelines whereby 'the construction of (airport) infrastructure projects ... represents a general measure of economic policy which cannot be controlled by the Commission under the Treaty rules on State aid' (see paragraph 19 which merely refers to the old 1994 guidelines), the issue seem essentially moot in consideration of the substantially 'imperceptible hiatus' between construction and use of the infrastructure which have been highlighted by the *La Poste* decision of the Court. Again, what clearly emerges from the new guidelines is that, except for the public duties above, virtually all the activities carried out through it are considered economic.

***Towards a modern approach: an application***

The previous analysis has shown that the liberalization/privatization process has produced two main effects in the State aid regulation of infrastructures. First, an increasing recognition that infrastructures may involve economic activities and may thus be subject to market criteria. Secondly, that these activities – and the relevant markets – may be several with the result that the advantage analysis should be

carried out at various levels. Finally, technology is another key-word in the field of infrastructure, as is evidenced by the topical issue of financing to broadband. [337]

The main teaching of *La Poste* is that, despite pursuing a public interest, infrastructures, and in particular the services provided through them, should necessarily be managed under market conditions. The market is the paradigm to determine whether an advantage is conferred. This has been confirmed by the analysis of the previous paragraphs on the more recent trends on infrastructures. Along the same lines, the Court has recently confirmed that the supply of a public service (in that case unrelated to any infrastructure) not consistent with market conditions, notably for no consideration, is liable to grant an aid. [338]

All this calls for a review of the traditional approach. Taking stock of the previous analysis, we could attempt test a new, modern approach with an application to the factual and legal background of the *La Poste* case.

It has been previously argued that there are good reasons for concluding that the provision of a *universal service* should generally be considered as an economic activity, to be tested against market criteria.

One of the crucial ideas underlying the concept of 'universal service' is affordability, which, like in *La Poste*, often materializes in a 'uniform tariff' for all users in the territory of the country.

What is often behind this tariff uniformity is cross-subsidisation, that is the financial support of one part of the business (the less profitable) by another part (the most profitable). The inevitable result is that the tariff applied to some users is *not commercially sound* because, as the Court itself recognised in *La Poste*, it may not cover the actual costs of delivering the service.

If the conduct is economic, and a market benchmark should be used in the advantage analysis, the conclusion is foregone: an advantage is conferred on those

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[337] The Commission generally looks with favour to financial assistance to broadband infrastructure and consider them as compatible aid: see IP/06/949; IP/06/755; IP/06/284; IP/06/214. The first negative decision was adopted very recently. It was considered that the area was already served by broadband networks and the aid was not necessary to remedy either a market failure or unaffordable prices: IP/06/1013. For a commentary on the policy in this area see Hecsey, Reymond, Riedl, Santamato and Westerhof (2005).

[338] Case C-126/01, *GEMO*, paragraphs 28 to 34. See also the Opinion of Advocate General Jacobs, paragraphs 64 to 78.

users. The impression is therefore that the legitimate *equity* justification which underlies the 'affordability' and 'uniformity' of the tariff should not be taken into account at this stage.

The advantage analysis may however present a final element of complication which leads us back to the assessment of the *construction* of the infrastructure.

The question is whether the fact that the government provides an infrastructure that the private sector 'would not have provided' *may* have an impact on the following advantage analysis of its operation. To put it differently, should the fact that the infrastructure is subsequently run according to market logic, and that the market price is paid for the access to it, lead us to forget that - but for governmental intervention - the infrastructure itself would not have seen the light, at least on the circumstances of the case?

The doubt is that the exclusion of any advantage should require that an assessment be carried out not only at the level of the *operation* of the infrastructure, which, as seen, need to occur according to market logic, but also at the previous level of its *construction*.

The crucial question is: what does 'the market would not have provided' actually mean?

It is difficult to distinguish between those situations that are *within* the market and those that are *beyond* it. Hypothetically, although costly, it is not impossible to create an infrastructure, irrespective of its extensiveness. On the premiss that the lack of private initiative does not depend on a market failure, should we therefore test the conduct of the government against a market benchmark? Or, rather, having identified a market failure (such as lack of competition in an industry which is *not* a natural monopoly), should we establish whether the government has *derogated from* its *general infrastructure policy*? [339]

If the answer to either question is that the government has granted an advantage by *creating* the infrastructure, this may have an impact on the following analysis of the *operation* of the infrastructure.

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[339] This criterion is analysed more in depth in the next section.

A note may be used to nicely conclude this paragraph on a modern approach to infrastructure under State aid rules.

The attentive reader has certainly noted that the focus of the debate has shifted to its natural location. Before being an issue of specificity, infrastructures are an issue of advantage. This is indeed an important conceptual clarification.

## The regulation of infrastructure under WTO subsidy rules

It is interesting to assess whether the general approach proposed in the EC context can be applied also here.

### *The exclusion of 'general infrastructure'*

The starting point is one of the forms of financial contribution under Article 1.1(a)(1)(iii). This provision refers to those cases where

> a government provides goods or services *other than general infrastructure* ....[340]

The intention seems to be that general infrastructure should not be covered by subsidy rules.

The argument whereby general infrastructures belong to the responsibilities of Member States and should thus be sheltered from the application of subsidy law should be immediately dismissed. Even sovereign prerogatives, such as the power to tax, find limitations in WTO law, for example in subsidy rules.

Two other explanations deserve more attention and focus on the already noted ambivalence of the term 'general'.

The seemingly accredited reading is that 'general' should be viewed as referring to the fact that the infrastructure at issue should not be specific, ie that it should not apply to the exclusive advantage of a 'specific enterprise or industry or group of

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[340] Emphasis added.

enterprises or industries'. McGovern (1995: 11.31-4) accordingly observed that the mention 'seems unnecessary in view of the general requirement in Article 2 ... that subsidies must be specific'. It could be noted that, since the determination of whether the use of infrastructures is specific or generally available is notoriously difficult, the legislator might in fact have preferred to cut it short and put the issue immediately outside the reach of the SCM.

Another possible explanation of the exclusion of general infrastructures from Article 1.1(a)(1)(iii) SCM is that, being general, infrastructures would not be liable to confer any advantage. 'General' is thus intended in its alternative meaning, ie as opposed to exception. In other words, only infrastructures that do not derogate from the general (infrastructure) policy of the government, and are hence 'general', should fall outside the scope of the law. It is worth repeating that this is the case not because they are not specific but because they do not confer an advantage in the first place.

This reading may be original. It can however be nicely reconciled with the wording of Article 1.1(a)(1)(iii) SCM for two main reasons. First, unlike the prevailing interpretation, which reads the phrase 'other than general infrastructure' as a pleonastic (read: useless) anticipation of the specificity test, it attempts to give the phrase, and within it, the term 'general', its own meaning. Secondly, the interpretation is the one which recognised that the more natural context of the issue of infrastructure is the advantage analysis. In this regard, we would interestingly see an anticipation of the advantage analysis at the level of the assessment of the financial contribution, which is not rare. See the next section on tax measures under Article 1.1(a)(1)(ii) SCM.

***Between traditional and modern approach***

Drawing inspiration from the previous analysis under EC law and the current trend of market liberalization and market logic expansion, two crucial remarks should be made.

First, the interpretation of general that has been suggested is premised on the fact that the infrastructure is provided by the government because of a market failure.

This is partly in line with the traditional approach to infrastructure (which sees them as naturally non-economic) but is increasingly put into question by the more and more significant role that, for various reasons, the private sector plays in the provision of infrastructures.

More fundamentally, it has been seen that the main indication of the expansion of market logic is that, once you have an infrastructure, irrespective of whether it is economic or not, this should be run economically, ie for profit. From the standpoint of the advantage analysis, this means that the operation of the infrastructure, that is the provision of its services, should be tested against market criteria.

The crucial legal question is whether these remarks can be taken into account in the construction of Article 1.1(a)(1)(iii) SCM which still seems to essentially reflect the old approach towards infrastructure.

This depends on the answer to two important questions.

First, does 'provision of infrastructure' also refer to the *services* supplied through it? A positive answer might find confirmation in the immediate context of subparagraph (iii): 'a government provides goods or *services* other than general infrastructure' which does not seem to exclusively confine the 'infrastructure' to its physical or static dimension but may well extend to cover its main function, ie the provision of services.

If the answer to the first question is positive, can 'general' be construed so as to include also those cases where the provision of the infrastructure is in line with the *general market* norm? Although this might require a bit more of interpretative inventiveness, an approach in this direction cannot be completely excluded.

**Conclusive remarks on the case-studies: the interplay between two forces**

After the examination of the complexities and difficulties inherent in commercial decisions and in their reviews, this section has analysed a particular element of complexity: the *public intervention in the economy*.

The two-case studies have shown that the interplay between the public intervention in the economy and the market is multilayered.

At a still superficial level both case-studies highlight that the mere fact that the government intervenes in the economy can make the market advantage analysis more difficult.

It is only at a deeper level, however, that the most intriguing and critical finding can be made. The background is the actual context of redefinition of the roles of public and private actors in the economy caused by the ongoing trend of market liberalization. The finding is the existence of two forces currently at work and partly moving in opposite directions. What the two case-studies do is to explain the relationship between public intervention in the economy and market advantage analysis from the respective viewpoint of either force.

The first case-study focused on the public intervention in the economy in its various forms and highlighted the impact of this 'public' force on the market advantage analysis, ie how it can make the identification of market benchmarks, whose applicability is not challenged in principle, particularly complex in the instant case.

What emerged from the second case-study is not only the confirmation of the significant impact of the public intervention in the economy but, more radically, the expansion of the market logic. This 'private' force is somewhat in opposition to the 'public' force. In the previous case it was the public intervention in the economy that produced an impact on the advantage analysis. Now, it is the 'market tide' which does profoundly influence the legal position of the public intervention in the economy in the first place (and consequently also the advantage analysis thereof). Crucially, as shown by the example of infrastructure, public conduct, whose status was previously at the very least ambiguous and substantially sheltered from the market and its rationale, is being redefined in the current liberalization scenario, it is more and more likely to be classed as economic, and finally subject to the market logic and its benchmarks.

As in any story, there has been a final twist. The writer has highlighted how, when there is a public presence in the economy, this cannot be ignored and may in turn have an impact on market logic.

## 3. The step forward: from difficulty to criticism

Drawing inspiration from the difficulties that have emerged so far, this closing section concentrates on two sets of arguments that make a step forward, by challenging the legitimacy - in terms of possibility and consistency - of using the market and its criteria to test the public intervention.

The two criticisms are strictly intertwined insofar as they both underline the risk of *discriminating* public actors towards private ones.

### First criticism: the fallacy of the market paradigm

#### The criticism and its refutation

This criticism does not concern the *difficulty* but, more radically, the *possibility* of using the market principle and its benchmarks.

The argument is that the conduct of public bodies in the market may not be assessed against *any* benchmark since it would not be possible to identify with precision the rules that guide private entrepreneurs. Market benchmarks are purely abstract. Malinconico (1999: 92) argues that it is difficult to say how a private investor would behave in a given situation as entrepreneurs do not necessarily behave in the same manner. The core is that every businessman is a person and persons are unique. Repeating a recurring observation, Parish (2003: 71) notes that

> [f]inance is not a science; it is not even an imprecise one, as it is based on predicting events whose occurrence depends upon people, whose conduct can never be formalised in a set of rules no matter how much data one has. ... Risk aversion is a quality that varies wildly from one investor to another. Even discounting different perceptions of risk, different investors may allow themselves to be motivated by a variety of different factors which are not strictly financial.

Even discounting personal differences, Malinconico (1999: 92) provocatively observes that if a rule in the market should be found this would be represented by uncertainty and lack of transparency. Predictions would not always be confirmed

according to a regular causal nexus since it is well likely that 'proprio l'improbabile costituisca la fortuna o la rovina di un investimento'.

With a caustic expression, Tarullo (1987/1987: 570-579) advances that the reference to a market standard would be just an exercise of *mimicry*. Ultimately, the imposition of an abstract standard of behaviour would result in a sort of *dirigisme* 'capace di mortificare l'impresa pubblica a fronte dell'impresa privata'. [341]

Therefore, the core of this criticism is that the market paradigm is in fact fallacious and, since it cannot apply to private investors, its imposition to public investors is all the more liable to *discriminate* them.

The fundamental nihilism of these critical arguments is too extreme. It seems clear that i) it is possible to talk of the market as a principle and of its underlying rules, and that ii) the reference to them is the most natural way to assess the public intervention in the market.

Although it is sometimes difficult to find or apply a precise benchmark, the conduct of private actors certainly follows certain principles resting on the fundamental premiss of economics, focussing on the rational, self-interested and profit-maximising *homo oeconomicus*. This premiss is often put into question. It is underlined that entrepreneurs not always behave rationally or with an individualistic goal. Parish (2003: 71 and 75) argues that a 'strong case can be made that private investors have regard to "social, regional-policy and sector considerations" ... as much as public investors' and that wealth increase is not necessarily the motive guiding investors.

This may well be true in some, if not many cases. The writer is aware of the huge debate concerning the very basic assumptions of economics, those that can be found in the first pages of any university textbooks, that agents in the market are *self-interested*, *utility-maximising* and *rational players*. *Behavioural decision theories*, for example, tend to criticise these assumptions and suggest that individuals may be motivated by a broader range of reasons. There is nonetheless considerable (empirical and common sense) evidence supporting the presumption that normally rationality is adhered to as well as that profit is the main motivator of economic

agents. Although sometimes difficult to uncover, criteria and benchmarks, which refer to the behaviour of a typical, and certainly to some extent idealized, economic operator set in that particular set of circumstances, can be found and developed. Truly, as with any idealization, adjustments may be needed but even factors such as uncertainty and lack of information can be duly taken into account in the application of these criteria.

Since the market has its rules, the conduct of economic actors operating within it is judged accordingly. If an undertaking does not behave in a commercially sound way it is punished. The company may lose shares to competitors and, in the most extreme cases, it is driven out of the market. The management may be put into question by shareholders and even dismissed. Now, it seems natural and logical that if a public body decides to enter the market it should follow its rules and its conduct should be reviewed on the basis of these rules.

Ultimately, this in not only natural and logical but also justified by the need *not* to *discriminate private actors*. The scrutiny according to these rules is particularly important for two reasons that specifically relate to public agents. On the one side, public bodies may well draw from considerable financial resources which may enable them to better withstand the misfortune of a commercial venture. On the other side, the kind of accountability in case of bad or simply unlucky public investments is less clear. Some stakeholders (consider the constituency of the region where an ailing industry heavily subsidised is located) may well support the investment despite its inconsistency according to commercial logic. These two concerns about a particularly deep pocket and the lack of commercial accountability may be partly addressed by the trends towards increasing budgetary constraints and more efficient use of public money which, for political and cultural reasons, seem be gaining more and more success in the recent years. The fact remains that, from a commercial perspective, the liaison between the government and the market is dangerous. Thus, more transparency with respect to the financial relations of governmental bodies (a good example is the EC Transparency Directive and its various requirements) and special scrutiny of the public intervention in the market is much needed.

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[341] Malinconico (1999: 92); see also Karyfis (2003: 413).

In conclusion, despite its shortcomings, a market benchmark can be found and used. The writer also tends to a have a more positive attitude than those, such as Smits (2005: 78), that accept it but consider it as 'la moins mauvaise des solutions'. He is certainly more in line with her subsequent remark that '[p]lutôt que de le supprimer, il conviendrait de le clarifier'. In this regard, a general suggestion is put forward in the next paragraph.

**The solution of flexibility**

Far from radically negating the existence of market rules, the concerns about a too abstract and rigid approach, which constitute the substance of the criticisms deployed against the market principle, can be addressed by using the necessary degree of *flexibility* in the identification and application of the appropriate benchmarks

With words equally applicable to EC law and WTO law, the Commission noted that

> the Commission realizes that [the] analysis of risk [which is demanded by any investment] requires public undertakings, like private undertakings, to exercise entrepreneurial skills, which by the very nature of the problem implies a wide margin of judgment on the part of the investor. Within that wide margin the exercise of judgment by the investor cannot be regarded as involving State aid. ...
>
> [i]t is not the Commission's intention to apply the principles in this communication (in what is necessarily a complex field) in a dogmatic or doctrinaire fashion. It understands that a wide margin must come into entrepreneurial investment decisions. The principles have however to be applied when it is beyond reasonable doubt that there is no other plausible explanation for the provision of public funds other than considering them as State aid. [342]

Although consistently repeated, this principle has not always been followed.

In the already cited *Bremer Vulkan* decision, the Court defended the need for a flexible approach and criticised the Commission for having considered, without

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[342] 1993 Communication, paragraphs 27 and 29.

adequate explanation, the stock market price as the sole determining factor in valuing shares, and noted that

> that view is too formal, rigid and restrictive. To apply that criterion absolutely and unconditionally, to the exclusion of all other elements, constitutes a purely mechanical exercise which can scarcely be reconciled with the system of the market economy and the economic choices made in the present case by undertakings of substantial size guided by prospects of profitability in the longer term. [343]

The use of 'average benchmarks' provides an interesting illustration of the possible ambiguity of the notion of flexibility. At first glance, the use of 'average' indicators seems to represent a straightforward application of the principle. A closer look, however, reveals that 'average' criteria are by definition inelastic. Average benchmarks have thus been criticised as too restrictive since they inevitably become *minimum* standards and thus *outlaw* any *conduct* which, albeit below average, would be *acceptable* to *some* private actors. [344] Hufbauer and Shelton Erb (1984: 101) ironically underline that

> This is a fairly rigorous test since, at any given time, approximately half the industrial firms in the country will be earning less than the average return on equity.

If used correctly, a flexible application of market criteria allows taking into account all the circumstances of the case and make the necessary accommodation. A couple of examples concerning public actors can be useful.

One common critique against the possibility of using market benchmarks to public entrepreneurs is that, even if a rule guiding private operators is found, there would be inherent *economic* differences between public and private undertakings, mainly

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[343] Cases C-329/93, C-62/95 and C-63/95, paragraph 36.

[344] The issue has recently come into prominence in the EC with the judicial review of a Commission decision which applied an 'average rate of return' test. The decision of the CFI in joined Cases T-228/99 and T-233/99 *WestLB* is not fully clear in dealing with the issue (see, eg, paragraph 258 of the judgment). See Hansen, Van Ysendyck and Zühlke (2004: 207); Smits (2005: 63-65).

dependent on the (allegedly) unlimited financial resources of governments. [345] A flexible application of market criteria should arguably allow taking these peculiar economic features into due consideration and permits for the necessary adjustments.

Another interesting problem. Suppose that the government manages to practice better conditions than those prevailing in the market, or to provide products or services that are not available in it. The doubt may be that this does not depend on superior efficiency, that is ability, of the agent but rather on its public status. However, the possibility that a public agent not only matches its market competitors (which is usually tested in the 'market' advantage analysis) but is in fact doing better than them cannot be ruled out. Although the numerous critics of public entrepreneurial and managerial potential might almost instinctively dismiss this possibility, as a matter of principle, it cannot be excluded. A non-abstract and non-dogmatic application of the market principle should represent a useful tool to analyse these situations.

This issue could have been tackled in the *Canada – Export Credits* dispute with respect to a particular type of equity guarantees. A little digression into the facts may be useful. Brazil argued that first loss deficiency guarantees (that is government guarantees to protect an equity investor from the risks inherent in the equity market), which had allegedly been provided by the Government of Québec to favour Canadian regional aircraft industry, 'quintessentially' conferred a benefit because they were not available in the market. Quite regrettably (from an academic perspective), the Panel did not address the interesting issue of whether or not, *as a matter of law*, the provision by a government of support not available in the market necessarily confers a benefit, because it eventually found that market equivalents did in fact exist. [346]

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[345] Hansen (2004: 203).
[346] Paragraph 7.341.

**Final gloss: advantage analysis and distortion**

This paragraph can find a nice conclusion with the analysis of another line of criticism of market criteria since this provides an interesting opportunity for reconsidering the role of the advantage analysis.

The critique leads to the conclusion that to say that an advantage is conferred because the conduct at issue is at odds with what market logic would require would rest on a simple, or simplified, idea of *distortion* of the market functioning. [347]

This may well be true but it is perfectly in line with the role of the element of the advantage in the broader context of the definition of subsidy and State aid. Although there is a clear link between the determination of an advantage and a possible negative effect on the market (we may recall the Appellate Body's finding about the 'trade-distorting potential' of conduct deviating from market logic), as chapter 5 will show, the assessment of whether a distortion has actually taken place should be carried out at a subsequent stage of the analysis. What the determination of an advantage, in the form of a derogation from normal commercial practice, does is just to provide an indication, certainly significant but not final, that a ('potential') distortion of competition and trade may have occurred.

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[347] Benitah (2001: 263).

## Second criticism: the inconsistency of the market paradigm with the public interest

The second criticism – which, it may be immediately said, does not seem to have much following anymore - highlights another aspect of alleged discrimination of public investors since the use of the market paradigm – whose soundness, in principle, is not challenged – would not take into account the crucial determinant of public intervention in the market, ie the pursuit of the *public interest*. The presence of public policy objectives would impede a parallel with private investors that by definition pursue purely individualistic goals. The 'private investor' criterion should therefore be substituted for a more comprehensive 'public investor' criterion, modelled on the public role of governments. [348]

Generally speaking, two issues need to be addressed. The first is a question of pure policy. Does the regulation at issue protect public policy objectives? If the answer is positive, the second question is more - albeit not exclusively – a technical matter. At what stage of the analysis these objectives should be considered? In particular, should their examination already occur at the level of the assessment of whether the conduct is commercially sound, ie of the advantage analysis?

It can be anticipated that the answer to the first question is positive. It is therefore useful to concentrate on the second issue which touches one of the *leit motifs* of this work, ie the interplay between scope and justification in the regulation of subsidies and State aids.

The reader might recall the Appellate Body's finding in *Canada – Aircraft* that the market should be the appropriate basis for comparison in the advantage analysis of the economic conduct of the government because of its ability to identify the 'trade-distorting potential' of the financial contribution.

This finding led the writer to formulate a broad hypothesis, ie that the advantage analysis of economic activity (in both WTO and EC law) should be based on those *economic* considerations that may signal a distortion to the competitive process and that *any* other consideration that might not be indicative from this perspective

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[348] For this line of argument with respect to the GATT and the EC see, respectively, Coccia (1991: 148 et seq), and Lesguillons (1991: 153 et seq).

should be excluded. A measure deviating from market practice would clearly suggest a potential of distortion of the market. The further implication was that public policy objectives could find with difficulty a place at this stage of the analysis. The time has now come to test that potentially far-reaching hypothesis in both WTO and EC law.

**WTO law**

The public intervention in the economy is normally justified by public policy considerations. Legally, it is important to determine the role played by the public interest, particularly in the context of the definition of subsidy. The issue is not new. Already in 1961 a Panel attempted to consider the 'reasons for subsidies' under Article XVI GATT but, as emerges from the report, this attempt was abandoned. Consequently, Jackson (1969: 387) seemed to conclude that

> the purpose of the study of a subsidy is not relevant to the question of whether it falls within the terms of Article XVI.

The 'reasons of subsidies' were discussed during the Tokyo Round and the ensuing Subsidy Code deals with them, although ambivalently.

Articles 8.1 and 11 simply recognise the possible opposite effects of subsidies (which may distort competition and trade and at the same time pursue important and legitimate socio/economic objectives). However, none of the provisions provide any indication on how to assess these effects, and, most importantly, how to balance them and solve any conflict. These provisions are thus more descriptive (of the ambivalent reality of subsidisation) than prescriptive (of how this ambivalence should be regulated).

The issue of subsidy objectives came out prominently in one of the last GATT disputes, *US - Carbon Steel I* where the Tokyo Subsidy Code was the relevant law. Matsushita, Schoenbaum and Mavroidis (2003: 267) note that the report was unadopted because the issues were negotiated in the context of the SCM

Agreement, and also suggest that the report had an impact on those negotiations (they particularly refer to the financial contribution).

For these reasons, and for the interesting statements contained therein, an attentive examination of the Panel report is justified.

***The definition of subsidy in the Tokyo Subsidy Code and public policy objectives: the US – Carbon Steel I dispute*** [349]

The case concerned the imposition of countervailing duties by the US on certain steel imports from the EC.

The EC argued that the standard of 'reasonable private investor' used by the US DOC to assess the provision of equity capital was contrary to the term 'subsidy' referred to in Article 4.2 of Part I of the Tokyo Subsidies Code because it failed to consider that governments often invest in pursuance of public policy objectives. In sum, 'government motives for investment, and therefore benchmarks for governments, [are] different from investment by private individuals' with the consequence that the appropriate standard should thus be that of a 'reasonable *public* investor'. This standard allows for the balancing of commercial factors and public policy objectives, considering that, unlike private investors, governments do not necessarily aim to achieve a maximum return on their investment. The test would *not* be met when the equity infusion is made 'for *social reasons only* and *without any serious chance of breaking even in the long run*' (emphasis added).

The US responded that 'public policy objectives [are] irrelevant to a determination of whether or not the provision of equity capital by a government [is] a subsidy'. The EC's reasoning was 'circular' since it 'could be used to rationalize any provision of equity capital by a government'. Moreover, the US claimed 'that the "reasonable public investor" criterion proposed by the EC was without logic in that from the standpoint of a government all subsidies could be said to be "reasonable"'. The quite blunt conclusion was that the 'EC was simply proposing an alternative test without explaining why the Agreement [ie the Tokyo Subsidies Code] required such a test'.

The importance of the interpretative issue was immediately recognized by the Panel: 'the rationale of the EC's argument was potentially applicable to a wide range of forms of government intervention'. Thus, 'the argument of the EC raised the *more general question* of whether or not, for the purpose of the determination of the *existence* of a countervailable *subsidy*, public policy objectives pursued by governments are to be taken into account by investigating authorities' (emphasis added).

The Panel analysed the overall Tokyo Subsidy Code for guidance. The learned reader may recall that a big interpretative issue raised by the Tokyo Code was whether Part I (on countervailing duties) and Part II (on international obligations) featured the same notion of subsidy. [350]

The Panel found nothing in the provisions of Part I to indicate that public policy objectives should be taken into account in order to determine whether a given measure constitute a countervailable subsidy. Although noting that a reference to the objectives of the subsidies was expressly made in Part II (in Articles 8.1 and 11), the Panel crucially noted that, *even in that context*, while recognizing the right of signatories to use subsidies in pursuance of various public policy objectives, Article 11 did

> not provide that such policy objectives are relevant to a determination of whether a particular practice constitutes a subsidy. Under Article 11, the existence of a subsidy and the public policy objectives pursued with that subsidy are separate matters. [351]

The important conclusion was that, under both Parts of the Tokyo Subsidies Code, the determination of whether or not a particular practice constitutes a (countervailable) subsidy *does not require* the consideration of the public policy objectives eventually pursued by the government. Consequently, only market considerations are relevant when determining whether a subsidy exists.

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[349] The relevant paragraphs of the report are from 434 to 451.
[350] Point which is now positively solved by the SCM Agreement: see Articles 1.2 and 10.

### *The benefit requirement in the SCM and public policy objectives*

The conclusion reached with respect to the Tokyo Subsidy Code may be quite easily transposed into the context of the SCM Agreement. [352] Not only is it now clear that only one definition of subsidy is applicable, but, most importantly, the fairly descriptive and inconclusive language of Articles 8.1 and 11 of the Code has been fully developed in the SCM Agreement to achieve a more prescriptive result.

The SCM Agreement *provided* for separate provisions for the definition of what constitutes a *subsidy* – and within it a *benefit* – on the one hand, and what subsidies are *non-actionable* because they pursue *public policy objectives* on the other. The writer used the past, 'provided', because the category of non-actionable subsidy expired in the year 2000. It does not seem however that this may affect the conclusion as to the role of public policy objectives and alter the structure of the SCM Agreement as it was designed. The only consequence of this lapse is that, at least for now, one important limb is missing. This issue is analysed below in chapter 5.

### EC law

The restrictive approach towards the role of public policy objectives in the context of the definition of aid was laid down in the mid-eighties in the *Meura* case. The Court found that the comparator of the public investor must be a private one which, in similar circumstances, takes a decision to invest

> having regard to the foreseeability of obtaining a return and *leaving aside all social, regional-policy and sectoral consideration.* [353]

In the *Hytasa*, Advocate General Jacobs observed that aid is granted whenever a State makes available to an undertakings funds which in the normal course of events would not be provided by a private investor applying ordinary commercial criteria

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[351] Paragraph 448.
[352] See, for example, Panel, *US – Softwood Lumber III*, paragraph 7.16.
[353] Case 234/84 *Meura*, paragraph 14 (emphasis added).

and *disregarding considerations of a social, political or philanthropic nature.* [354] The Court concluded that it is necessary to distinguish the obligations which the State must assume as owner of the share capital of a company and its obligations as a public authority. [355]

This is the current state of the law. It is however useful to analyse two cases where the issue of whether a different test should apply to public investors was thoroughly discussed. This analysis will also provide the opportunity for a parallel with the GATT.

In *Alfa Romeo* the Court drew an important distinction between ordinary investors and holdings or groups of companies, by highlighting that these may pursue different objectives in their investment decisions. In *ENI-Lanerossi* the Court accepted that a parent company may decide to cover the losses of one subsidiary for a limited period in order to enable it either to reorganise it or to close down under the best possible conditions, and in doing so it 'may be motivated not solely by the likelihood of an indirect material profit but also by other considerations, such as a desire to protect the group's image or to redirect its activities'. Nevertheless, in both cases the Court underlined that injection of capital that disregard any prospect of profitability, even in the long term, should be regarded as aid. [356] It is interesting to note that the Court's reasoning makes reference only to factors, such as profitability, restructuring plan, overcapacity, image, etc, that are inherently economic.

Advocate General Van Gerven took a more open approach in his two Opinions.

In *ENI* he underlined that, although both private and public undertakings should always be guided by 'the laws of the market place', even a private investor, and particularly if a large holding company, *would not be wholly uninfluenced by considerations of a social nature or of regional or sectoral policy.* Quite clearly, this would *a fortiori* apply to public holding companies. [357]

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[354] See Joined Cases 278 to 280/92 *Hytasa*, paragraph 28 of the Opinion.
[355] Ibid, paragraph 22.
[356] *Alfa Romeo*, paragraph 20; *ENI*, paragraph 22.
[357] Paragraph 14.

In *Alfa Romeo* he developed his thought and introduced the concept of *reasonable* investor. [358]

This would include ordinary and stable private investors. However, while the ordinary investors would not be interested in a shareholding significant enough to influence the management of the company, stable investors, such as holding companies, would possess, or in any event wish to possess, shareholdings large enough to influence the governance of the undertaking. Both would be guided by considerations of profitability. Stable investors however would consider a longer period of time, and – quite interestingly - would also have regard to *considerations of employment and economic development in a given region or sector.* A passage of the Opinion deserves a full quotation because it attempts to explain where the balance between profitability and other objectives is set.

> In shifting the emphasis from the 'private' to the 'reasonable' investor, I am not suggesting that the requirement of profitability may be left out of account. The reasonable investor or holding company (whether from the private or public sector) must, in order to act responsibly, secure a normal return on its investments, even it in so doing it may have regard to a wider social and economic context and over a longer time span. It is above all in the case of public holdings that the profitability requirement must be underlined, since they are under less pressure than private holding companies to make profit for shareholders who (directly or indirectly) are 'ordinary' private investors, given that the risk capital of public holding companies is directly or indirectly financed by public funds. [359]

It is now interesting to make a step backward and compare the criterion of the 'reasonable investor' suggested by Van Gerven (which was not supported by the Commission and was rejected by the Court of Justice) and the position that the EC (ie the Commission) took in the GATT in the *US - Carbon Steel I* dispute where they sponsored a 'reasonable public investor' test.

Leaving linguistic differences aside, the substance is remarkably similar, if not identical. Suffice rehearsing the test advanced in the GATT dispute to realize this. The 'reasonable public investor' standard would allow for the balancing of

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[358] See paragraphs 11 and 12 of the Opinion.

commercial factors and public policy objectives, on the premiss that, unlike private investors, governments do not necessarily aim to achieve a maximum return on their investment. The test would not be met when the equity infusion is made 'for social reasons only and without any serious chance of breaking even in the long run'.

The balance between the profit imperative and public policy objectives is just the same. One could then ask whether the adoption of an apparently more lenient approach towards public investment in the GATT as compared to that embraced in its internal system is justified.

In the writer's view, the answer should be positive, and this for various reasons.

The political and litigation context comes immediately into prominence. In *US-Carbon Steel I* the EC is 'defending' the conduct of its Member States. In *Alfa Romeo* and *ENI* it is closely scrutinising it.

The difference between the two situations can however be found at another, properly legal, level. It can be noted that the 'reasonable investor' test of Advocate General Van Gerven is universal inasmuch as it applies to both public and private investors. The 'reasonable *public* investor' test put forward by the EC is contrasted to the 'reasonable *private*' test defended by the US. It draws a clear distinction between private investors and public investors and aims to apply *only* to the latter's conduct in the market.

We come to the core of the issue. The more lenient approach towards public investors adopted by the Commission in the GATT context can be understood by properly considering the fundamental structural difference between the two legal frameworks – the Tokyo Subsidy Code on the one side and EC Treaty on the other. The former represented a regulation of subsidies at a still very embryonic stage. The regulation of public policy objectives, and their relative weight in the balance with the distortions produced by subsidies, was totally unclear. The inherent ambivalence of subsidies (distortive but legitimate) could not find a sufficiently prescriptive regulation which could provide equilibrium as well as clarity. By contrast, the EC Treaty already displayed a more mature legal framework since the

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[359] Paragraph 12.

beginning (1957), with specific provisions addressing the public interest justifications (Articles 87(2) and (3) and Article 86(2) EC), clearly separate from the general definition/prohibition of distorting State aid and administered through a centralised and supranational system of control. Interestingly, a similar situation was present in the SCM Agreement before the expiry of the non-actionable category (which was expressly modelled on EC law).

Consequently, in EC law the distinction between economic and public policy considerations is clearly embedded in the idea that the concept of State aid is *objective* and its assessment is *effect-based* and that *causes and aims* of the measure are *not relevant.* [360]

It is interesting that all the cases where these principles were laid down involved tax measures, that is a form of and *inherently public* (and hence non-economic) conduct. The definition of the role of public policy objectives in the advantage analysis is particularly complex in this area. The government is by definition acting in the public sphere and the various public motives are difficult to disentangle. Those strong statements, which are formulated in general terms, are *all the more* significant when it comes to assess the *economic* activity of governments where the distinction between commercial and public interest considerations should be more apparent.

In conclusion, if the action of the government confers an advantage and also pursues policy objectives, it seems that these should not be considered at the stage of the definition of State aid, and in particular at the level of the advantage analysis. The crucial factor is that the system already provides specific provisions where the public interest should be taken into account.

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[360] The *loci classici* are Case 173/73 *Italy* v *Commission*, paragraph 13; Case 78/76 *Steinike*, paragraph 21; Case T-67/94 *Ladbroke*, paragraph 52.

## Conclusions: distinction between market and public interest

### *One leit motif, two scenarios*

It has been seen that one of the recurring themes of this thesis is the analysis of the interplay between scope and justification in the regulation of subsidies and State aids. This issue enquires the role played by the public interest in the various stages of the legal analysis.

Generally speaking there are two possibilities. Under the first, there is no advantage because the measure pursues a public objective. Crucially, the public conduct falls outside the scope of application of the definition and hence of the rules. The alternative is that an advantage is established (in the case of economic activity, because the conduct is not commercially sound). If the other requirements of the definition are fulfilled the rules apply and in some cases the conduct is also prohibited. However, the public interest may come into play at a second stage and the measure may eventually be justified.

### *The state of the law: distinction*

The 'political and legal' distinction of the two scenarios can already be appreciated but becomes naturally vivid when it is applied to the two legal systems under examination.

In the WTO it makes a great difference to hold that a measure does not constitute a subsidy in the first place or to consider it a subsidy which is (was) non-actionable. Whilst in the former case the measure falls outside the scope of application of the SCM Agreement altogether (and, if any, may be governed by other provisions), in the latter it is still subject to the SCM Agreement and to obligations, controls, and actions thereunder (notification, surveillance, and, quite crucially until – and provided that - the category of non-actionability is resurrected, to unilateral and multilateral actions). Not only the substantive but also the procedural, institutional and constitutional implications of this distinction cannot pass unnoticed.

The situation in the EC is similar. The case where the measure does not confer an advantage and hence cannot be a State aid is very different from that where there is

a State aid which is in principle prohibited but is eventually 'compatible with the common market'. As above, this difference does not only concern the substantive rules that are applicable (in the first scenario State aid rules do not apply, in the second case they do). Most significantly, it has an impact on the procedural, institutional and eventually constitutional setting of the EC system of State aid control. It should be recalled that, in the EC system of State aid control it is only for the European Commission to authorise planned State aid measures. This is done through a complex balancing between distortions of competition and other positive effects in the public interest.

The examination of WTO and EC law in the previous paragraphs indicates that the first scenario seems to be prevailing. The advantage analysis of market activity requires a *distinction* between *market logic* and *public policy objectives*. It is natural that the advantage analysis of the economic conduct of the public investor is tested against the market and its benchmarks. Although this assessment should be flexible, this cannot go so far as to forget commercial logic in favour of public policy objectives. In a word, both systems seem to endorse, at least with respect to the assessment of the economic activity of governments, a *distinction between scope (which is defined by the market paradigm) and justification (which is defined by the public interest).*

The critics of a too harsh treatment towards public investors and the public interest might be reassured by saying that the story so far is not about irrelevance but of distinction.

## 4. A word of conclusion: the redemption of the market paradigm

We have seen difficulties, complexities and criticisms of the market paradigm. Not only has it been advanced that the identification and application of market benchmarks may be complex and their review a difficult exercise. It has more fundamentally been argued that the use of the market as a comparator is neither possible nor legitimate.

Mainly in analysing the criticisms against the market principle, the writer has attempted to offer some solutions which could take stock of the difficulties and concerns and reach a balanced view of the utility of the market logic and its benchmarks in the advantage analysis of the economic activity of governments.

The two key propositions have been i) that a *flexible approach* is needed in the application of the complex market criteria, especially at the level of the review of business decisions, and ii) that, albeit legitimate, *public interest* considerations should be *distinguished* from the *market* analysis and should not be considered at the level of the advantage analysis (and, more generally, of the definition).

## IV. Non-economic activity and normative benchmarks

In this section the analysis focuses on the advantage analysis of those forms of action, such as taxation and regulation, that are inherently public inasmuch as they are naturally non-economic.

The analysis mainly focuses on tax measures, ie on all those measures whereby governments exercise their authority to impose and levy monetary payments (eg direct and indirect tax, social contributions).

This depends on two reasons. On the one hand, unlike regulation, this form of conduct straight falls under the rules. Further, fiscal policy is increasingly becoming one of the most common means to grant assistance, thus providing a great wealth of cases and issues to concentrate on in both systems.

On the other hand, the observations made in the tax context are of more general validity and could certainly be extended to regulation, should this be caught by the rules. This is true also for the remaining candidate for non-economic activity, public goods, and in particular infrastructures, an area currently subject to redefinition.

The separate analysis of WTO and EC law is followed by a closing section for comparative and critical remarks.

# 1. WTO law

## Tax measures

### A methodological premiss: the advantage analysis between financial contribution and benefit

The starting point of the advantage analysis for tax measures in WTO law should be the interpretation of the phrase 'government revenue that is otherwise due is foregone or not collected' in Article 1.1(a)(1)(ii) SCM.

Since it would appear more natural to concentrate on the concept of benefit under Article 1.1(b) SCM, rather than on one of the forms of financial contribution, it is important to justify this choice immediately to make it clear that the writer is not attempting to drop one of the two criteria (notably the benefit) or to conflate them.

In general, although financial contribution and benefit are different requirements and in principle should be interpreted according to their own criteria, they can certainly represent part of the relevant context of each other. This is particularly so in this case where the form of financial contribution under Article 1.1(a)(1)(ii) is clearly linked to the benefit analysis in various respects.

To understand this point, it is useful to compare the assessment required by the phrase 'otherwise due' in subparagraph (ii) with the analysis of governmental activities in the *market* under the 'benefit' requirement.

In an already quoted passage in *Canada - Aircraft* the Appellate Body held:

> [w]e also believe that the word "benefit", as used in Article 1.1(b), implies some kind of comparison. This must be so, for there can be no "benefit" to the recipient unless the "financial contribution" makes the recipient "better off" than it would otherwise have been, absent that contribution. [361]

In the *US - FSC* dispute the Appellate Body construed the phrase 'government revenue that is otherwise due is foregone' in Article 1.1(a)(1)(ii) SCM as follows:

> [i]n our view, the "*foregoing*" of revenue "*otherwise* due" implies that less revenue has been raised by the government than would have been raised in a different situation, or, that is, "otherwise". ... We ... agree with the Panel that the term "otherwise due" implies some kind of comparison between the revenue due under the contested measure and revenues that would be due in some other situation. [362]

The language of the two passages is strikingly similar and the analogy is particularly interesting.

First, both terms 'benefit' and 'otherwise due' would 'imply some kind of comparison'. This comparison is between the actual case and another benchmark situation that would have occurred 'otherwise' (respectively, the 'marketplace' and the appropriate 'tax rules'). [363]

Secondly, the language of both cases, in a more or less direct way, hints at the fact that this derogation from the relevant benchmark may confer an advantage.

Indeed there is a difference in the two passages because there is more emphasis on the favouring effect of the measure in the first case (the financial contribution is expressly said to make the recipient 'better off') than in the second (where the foregoing of revenue otherwise due logically implies that 'less revenue' is raised). It could not have been any different if it is considered that the former case concerned the interpretation of the 'benefit' requirement. Nevertheless, this difference is arguably more a matter of *formulation* rather than of *substance* as the collection of 'less revenue' than would have occurred otherwise not only alludes to but almost invariably gives rise to a benefit for the exempted subject.

The analogies (and the difference) that we have just found can be explained by considering both the *fabric* and *position* of the advantage analysis.

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[361] Appellate Body, *Canada - Aircraft*, paragraph 157.
[362] Appellate Body, *US -FSC*, paragraph 90.
[363] See Appellate Body, *Canada - Aircraft*, paragraph 157; Appellate Body, *US - FSC*, paragraph 90.

***The fabric and the position of the advantage analysis***

Conceptually, it is possible to divide the advantage analysis into two steps. The first is whether the measure at issue provides a *derogation from a given benchmark*. The second is whether this deviation operates *to the advantage of* the undertakings at issue.

The position of these two steps in the definition of subsidy in the SCM Agreement is different in the advantage analysis of respectively economic conduct and taxation. Whereas in the case of market conduct they are *both* located in the context of the benefit requirement under Article 1.1(b) SCM, in the case of tax measures they can already, and mainly, be found at the level of the financial contribution.

Subparagraphs (i) and (iii) of Article 1.1(a)(1), which regulate governmental economic activities, merely identify the form of the conduct of the government (transfers of funds, provision of goods and services, procurement of goods) but are quite neutral with respect to both i) its derogating character and ii) its favouring effect, in a word to its *advantage*, thus completely leaving this determination to the following and separate analysis of the benefit requirement under Article 1(b) SCM.

On the other hand, the identification of the form of financial contribution under subparagraph (ii), which refers to the case of 'foregoing' or 'non-collection' of government revenue 'otherwise due', is not neutral but *already includes* a test which inquires i) whether the conduct of the government derogates from a benchmark situation (as it is hinted by the 'otherwise due' language) and - to a large extent - also i) whether it favours the tax payer (as it is suggested, as a matter of logic, by the 'foregoing'/'non-collection' language). [364] Indeed in these cases the subsequent analysis of the benefit under Article 1.1(b) is usually straightforward. Once it has been established that government revenue, otherwise due, has been foregone or not collected, the existence of a benefit can be safely assumed. [365]

In sum, what we substantially see in the case of tax measures is *the anticipated insertion* (under paragraph (ii) of Article 1.1(a)(1) SCM) of the (two steps of the) *advantage*

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[364] It is amusing to ask whether it is possible to formulate the conduct of (preferential) fiscal treatment in a more neutral way similar to that of market conduct. If one wants to reach some precision, it is not possible to phrase subparagraph (ii) differently. As soon as mention is made to the *foregoing* or *non-collection* of revenue, the inevitable implication - which does not need to be expressly worded - is that revenue that was 'otherwise due' has been waived to the 'advantage' of the tax payer.

[365] Cf Panel, *US - FSC*, paragraph 7.103; Panel, *US - FSC (21.5 EC)*, paragraph 8.46.

*analysis* which is usually carried out under the benefit of Article 1.1(b) SCM. It is this anticipation that in the writer's view justifies the examination of the first provision in this context.

## Case study: the *US - FSC* dispute

The construction of the 'otherwise due' requirement under Article 1.1(a)(1)(ii) SCM was one of the crucial issues in the celebrated *US - FSC* dispute.

The significant findings of the Panels and the Appellate Body makes this dispute an excellent case-study to analyse the various tests and benchmarks used to determine whether the measure at issue is liable to confer an advantage and constitute a tax subsidy under WTO law.

### *Introduction*

Traditionally under US tax law income earned outside the country is taxed if there is an effective connection with a trade or business in the United States (principle of world-wide taxation).

The *FSC* legislation introduced an exemption from taxation on a portion of the 'foreign trade income' of certain companies established outside the United States (*Foreign Sales Corporations*, or *FSC*). [366] The *FSC* tax exemption was adopted by the US to replace its predecessor *DISC* to comply with a 1981 Understanding which ended the impasse over the *Tax legislation* cases. [367] With this Understanding the parties crucially accepted that 'economic processes located outside the territorial limits of the exporting country *need not be subject to taxation by the exporting country and should not be regarded as export activities*' (emphasis added). Two conditions had to be

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[366] Various requirements had to be met for the definition of both 'foreign trade income' and *FSC*. The law is thoroughly exposed by the Panel at paragraphs 2.1 to 2.8.

[367] With the expression '*Tax legislation* cases' reference is made to the four disputes (*US - DISC*, *Belgium - Income Tax*, *France - Income Tax* and *Netherlands - Income tax*) decided in 1977 with four panel reports. These reports concluded that the US *DISC* tax exemptions on the one side and the application of the territorial systems of taxation of France, Belgium and the Netherlands on the other constituted export subsidies. The required unanimity to adopt the reports could not be found until a settlement was finally agreed with the 1981 Understanding which was adopted by the Council. On the *DISC* cases and the *FSC* legislation there is an extensive literature. See, eg, Jackson (1978); Hufbauer & Shelton Erb (1984: 57 to 63), Gray (1985); Klabbers & Vreugdenhil (1986/1987); Weizmann (1987); Qureshi and Grynberg (2002); Hudec (1993: 53 to 100) and id (2003).

fulfilled: that the exemption be limited only to *foreign economic processes* (ie sales activities taking place outside the government's territory) and to *foreign-source income* (which would have been ensured by calculating the exempt income on the basis of arm's length pricing).

Leaving aside the debated issue of the legal effect of the 1981 Understanding, according to most observers, the *FSC* tax exemption did not in any event meet the conditions set out above. The FSC legislation required very little genuine foreign economic activity and that the pricing rules' percentages did not comply with the arm's length principle. [368] Eventually, the EC alleged a violation of inter alia the SCM Agreement and in 1997 filed a complaint with the WTO.

One of the debated points in the *FSC* dispute, which directly concerns the advantage analysis in taxation, concerned the interpretation of the 'otherwise due' requirement under Article 1.1(a)(1)(ii) SCM.

### *The 'but for' test between simplicity and inadequacy*

#### *The Panel: the choice for simplicity*

After underlining that the reference benchmark in the interpretation of the 'otherwise due' requirement must be found in the tax regime of the defending Member State, [369] the Panel put forward a test which should be used in determining whether revenue otherwise due has been foregone. In a repetitive passage it noted:

> [i]n accordance with its ordinary meaning, we took the term '*otherwise* due' to refer to the situation that would prevail but for the measures in question. It is thus a matter of determining whether, absent such measures, there would be a higher tax liability. In our view, this means that a panel, in considering whether revenue foregone is 'otherwise due', must examine the situation that would exist but for the measure in question. Under this approach, the question presented in this dispute is whether, if the FSC scheme did not exist, revenue would be due which is foregone by reason of that scheme. [370]

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[368] Cf Hudec (1993: 95 to 98); id (2003: 180).
[369] Panel, *US - FSC*, paragraph 7.43.
[370] Ibid, paragraph 7.45.

The Panel interpreted the 'otherwise due' phrase as referring to the situation that would prevail *but for* or *in the absence of* the measure in question. The inherent 'instability' of this 'but for' test (and, more generally, of the 'otherwise due' language) [371] is evident. In particular, the problem in the 'but for' approach is that it does not offer any solid indication about the *benchmark* against which the measure has to be tested. [372] This lacuna was acknowledged by the Appellate Body when it underlined the need to refer to 'some defined, normative benchmark'. [373]

The risk of this uncertainty is that the test be interpreted in a *mechanical* fashion by limiting the assessment to the *form* of the tax system without going beneath its surface.

This danger was highlighted by the EC that were arguing that the 'but for' test was too much 'formalistic' and that they would have preferred a different test giving more consideration to 'substance' rather than to 'form'. [374] What was necessary was to identify 'a deviation from or exemption to the *generally* applied rate or basis for collection' of taxes (emphasis added), [375] which corresponds to our 'derogation test'. This would occur when the exemption or exclusion from taxation is 'not based on neutral and objective criteria, ie, the exemption or exclusion is special or programmatic'. [376]

Despite heavily criticising this test (and, in particular, the complexity of identifying general rules and exceptions, and the risk of confusion with the specificity test), the US did not propose any clear alternative test but generally shared the view as to the 'desirability of avoiding results that exalt form over substance' and 'the need to have clear rules'. [377]

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[371] Benitah (2001) page 188.
[372] Using a mathematical jargon, 'saying that an exemption amounts to "foregone revenue that is otherwise due" has no meaning if we do not have a universal reference set in which this exemption appears as a departure from the general regime', Benitah (2001: 188). The problem is that it is possible to identify different universal reference sets in any given case with the consequence that the assessment of the 'otherwise due' requirement may well lead to different results (ibid, 188 and 189).
[373] Appellate Body, *US - FSC*, paragraph 90. Using the mathematical language of the previous note, we could describe the ***defined*** normative benchmark as the ***appropriate*** universal reference set.
[374] ibid, paragraph 4.1063.
[375] ibid, paragraph 4.591.
[376] Panel, *US - FSC*, paragraph 4.1057.
[377] ibid, paragraphs 4.1095 to 4.113.

The Panel acknowledged that there was a certain degree of convergence between the 'but for' test and the 'derogation test' as, in all probability, in many cases the same result would have been generated. [378] It nonetheless underlined that the 'but for' approach seemed more 'grounded in the actual text of the SCM Agreement' than the 'derogation' test. [379]

The conclusion that the 'but for' test is more in line with the wording of Article 1.1(a)(1)(ii) SCM than the 'derogation' test is however arguable.

The main reason for the adoption of the 'but for' approach was that it has *never* been really controversial that the FSC exemption constituted a tax subsidy. The application of the 'but for' test was therefore sufficient to show *in the case at hand* that in the absence of the measure in question there would have been a higher tax liability.

In this context, the risks of excessive formalism that could derive from the counter-factual analysis of a 'but for' test (which had been hinted at by the EC) were not as concrete as the complexities of the more sophisticated search for general rules and exceptions of the derogation test (which had been exhaustively warned against by the US).

In short, the Panel opted for the route that, under the circumstances of the case, was the more straightforward and economical. It was thus mainly a *choice for simplicity*. The judicial philosophy underlying this choice is that simple cases require simple solutions.

*The Appellate Body: the recognition of inadequacy*

The doubts about the *inadequacy* of the 'but for' test and, in particular, about its risks of excessive formalism emerged more prominently at the appellate level.

The Appellate Body made it immediately clear that the 'otherwise due' phrase requires the identification of 'some defined, normative benchmark against which a comparison can be made between the revenue actually raised and the revenue that

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[378] ibid, paragraph 7.46.
[379] ibid..

would have been raised 'otherwise". [380] In a passage which nicely combined the principle of sovereignty of Member States in tax matters with the principle that WTO obligations must be respected, it quite generally stated that this benchmark must be found in the domestic tax rules of the Member State in question. [381]

The moment came to assess the 'but for' test:

> the Panel found that the term 'otherwise due' establishes a 'but for' test, in terms of which the appropriate basis of comparison for determining whether revenues "otherwise due" is "the situation that would prevail but for the measures in question". In the present case, this legal standard provides a sound basis for comparison because it is not difficult to establish in what way the foreign source income of an FSC would be taxed 'but for' the contested measure.

In line with the previous remarks about the simplicity of the characterisation of the *FSC* exemption, the Appellate Body thus approved the use of the 'but for' test 'in the present case' because of its lack of difficulty. It could have stopped there. The world trade court, however, decided to go on to comment about the general applicability of the 'but for' test in other situations.

After underlining that it had 'certain abiding reservations' about applying any legal standard such as the 'but for' test 'in the place of the actual treaty language' (and thus rejecting the possible suggestion that the 'but for' test was no more than a nice rephrasing of 'otherwise due'), it noted

> we would have particular misgivings about using a 'but for' test if its application were limited to situations where there actually existed an alternative measure, under which the revenues in question would be taxed, absent the contested measure. It would, we believe, not be difficult to circumvent such a test by designing a tax regime under which there would be no general rule that applied formally to the revenues in question, absent the contested measures. [382]

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[380] Appellate Body, *US - FSC*, paragraph 90.
[381] Ibid.
[382] Appellate Body, *US - FSC*, paragraph 91. In the implementation phase (*US - FSC (Article 21.5 EC)* paragraph 91) the Appellate Body repeated the same concept: 'in identifying the normative benchmark, there may be situations where the measure at issue might be described as an 'exception' to a "general" rule of taxation. In such situations, it may be possible to apply a "but for" test to examine the fiscal treatment of income absent the contested measure'.

The (un)expected conclusion was therefore that

> although the Panel's 'but for' test works in this case, it may not work in other cases. [383]

The risks of excessive formalism of the 'but for' test which had been simply hinted at by the EC before the Panel (and partly acknowledged also by the US) were now directly addressed by the Appellate Body which, interestingly, did so *ex officio* as none of the parties had advanced any criticism to the Panel's interpretation. [384]

The warning was that the advantage analysis should not rely only on a *mechanical* process of exclusion which could work only if there is a *clear alternative* in the system which would *formally* have applied in the absence of the contested measure.

This was the case of the *FSC* exemption where it was not difficult to establish that the 'foreign-source income of an FSC would be taxed "but for" the contested measure'. [385] In other cases, however, the application of a formalistic and mechanical 'but for' test may be unreliable. Its adoption could even create an incentive on Member States to design their tax system in a way to render it difficult to identify an alternative measure and thus easily circumvent the test.

Despite a tenuous hint at the 'derogation test' (which emerges from the solitary reference to an alternative 'general rule' at paragraph 91), the Appellate Body did *not* proceed further by suggesting an alternative test for those cases where the 'but for' approach is not provide a useful tool.

The original proceedings thus finished with new doubts, those on the alternative test(s) that should replace, or at least complement, the 'but for' test.

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[383] Appellate Body, *US - FSC*, paragraph 91.
[384] Ibid.

*Preliminary conclusions: the 'but for' test is insufficient*

The original proceedings of the *US - FSC* dispute show that the biggest difficulty of the 'otherwise due' requirement is the determination of the appropriate 'normative benchmark' against which to test the tax measure at issue.

Neither the Panel nor the Appellate Body provided a comprehensive explanation of how the 'otherwise due' requirement operates. They generally stated that the basis of comparison is constituted by the 'rule of taxation that each Member, by its own choice, establishes for itself' but failed to show *how* to determine what is the actual 'normative benchmark' against which to test the measure.

The 'but for' test has not passed the test. It did not prove to be fully dependable as it seemed to work only in the more straightforward cases being ineffective in more complex ones.

What would be required is a *more sophisticated theoretical framework* able to tackle the inconveniences of a too formal test. It is only by going beneath the surface that one is able to explore the mechanism of the tax system and to determine whether the measure at issue confers an advantage and is a tax subsidy.

Along this path, both the Panel and the Appellate Body made an interesting effort of elaboration in the implementation phase where they indicated new standards of assessment.

## *More sophistication: derogation test and comparative test*

*Panel (Article 21.5 DSU): a derogation test in disguise?*

The implementation Panel took note of the *caveat* of the Appellate Body and accepted that the interpretation of the 'otherwise due' requirement cannot rest on a 'purely mechanical' or 'formalistic' exercise. [386]

Nevertheless, it did not formulate in a clear fashion the test that was to be applied. The theoretical apparatus deployed is rather sibylline [387] with the result that the

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[385] Appellate Body, *US-FSC*, paragraph 91.

[386] Panel, *US - FSC (Article 21.5 EC)*, paragraphs 8.14 and 8.15.

[387] With statements like '[t]he key is to apply critical judgment to the facts of the matter' (paragraph 8.17); 'while the enquiry cannot be inherently presumptive or speculative, neither can it be so exacting or confining

ultimate suggestion is the usual but inconclusive finding that 'the key point [which in fact is merely the 'starting' point] is that the tax rules applied by the Member in question are the *basis* for the comparison'. [388]

Leaving aside the declarations, the examination of the Panel's analysis of the implementing ETI legislation is more revealing. The clear impression is that the Panel is implicitly resorting to a *derogation test*, focused as it is on the affirmation of the *exceptional* character of the new implementing legislation. [389] The Panel continues to underline the 'several stringently selective qualitative conditions and quantitative requirements' that must be satisfied for the income to be excluded from taxation. [390]

As Professor Hudec observed in one of his last works, the most illuminating paragraph in this regard is number 8.29. To better appreciate this reading the writer thought it appropriate to report the passage together with Professor Hudec's ingenious bracketed suggestions on the underlying references to the concepts of 'general' and 'specific'.

> ... Indeed, discerning what might be described as 'the prevailing domestic standard' for a particular tax regime may be a particularly exacting exercise. In more common usage, it might be rather difficult to discern what is the exception, as it were, and what is the [general] rule ... [W]e are not, in this dispute, presented with a situation of such complexity. The dispute does not involve a debatable call as to whether the glass is half-full or half-empty. As outlined above, we have looked at the essential shape and the rationale that is exhibited. In examining that, we have weighed such considerations as the degree of conditionality [general-specific?], the range of limitations [general-specific?] and the manner in which the measure at issue related to the overall regime [general-specific?]. Taken together, they enable us to assess the nature of the relationship of the measure at issue and the overall regime [general-specific?]. That is precisely [?] how one is in a position to arrive at the judgment required by the terms of the SCM Agreement. [391]

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that it is necessary to attain the level of establishing a mathematical deductive relationship between the contested measure and the default situation' (paragraph 8.18), 'sound basis for exercising reasonable judgment' (paragraph 8.19).

[388] Panel, *US - FSC (Article 21.5 EC)*, paragraph 8.18 (emphasis in the original text, the comment between brackets is of the writer).

[389] See Panel, *US - FSC (Article 21.5 EC)*, paragraphs 8.21 and 8.30.

[390] Ibid, paragraph 8.21.

[391] Ibid, paragraph 8.29. See Hudec (2003: 196).

The first preliminary observation is that this analysis shows the intriguing overlap between advantage and specificity analysis which is indeed a recurring theme (for an explanation of the interplay between and distinction of these two concepts see below the section on EC law).

Most importantly for the current analysis, as Hudec (2003: 186) underlines, it shows the theoretical framework of the participants in the *FSC* case, whereby national tax laws seems to be perceived as being organised on the basis of *general principles* or *rules*.[392] In this framework, a measure amounts to a subsidy because it constitutes an exception to or a deviation from a general rule operating to the advantage of the undertakings concerned.

Although this framework is not the only possible reading of the 'otherwise due' requirement, it can easily be applied to its counter-factual analysis. This derogation test consists in assessing whether the measure at issue deviates from the regime or rule that *would otherwise have applied because of its general character*. This would give substance to the 'otherwise due' requirement, providing the interpreter with a useful tool to avoid the inconveniences of the more simple version of the 'but for' test (such as the excessive formalism and risk of circumvention, or the lack of consideration of the general or exceptional nature of the measure in question).

Admittedly, the derogation test is not free from difficulties. The search for general rules and exceptions may be a particularly complex exercise, which explains the reluctance to expressly adhere to it (cf in this regard the Appellate Body's remarks in the implementation report).

Its force of persuasion and its utility have however been impliedly recognised by the implementation Panel which has implicitly but clearly based all its reasoning on it.

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[392] The author points out that these general principles are at different times referred to by the Panel or the Appellate Body as 'prevailing standards' or 'general rules'. By contrast, the term 'normative benchmark' does not seem to be necessarily limited to general rules.

*Appellate Body (Article 21.5 DSU): the 'new' comparative test*

The story did not find an end in the ambiguous application of the derogation test by the implementation Panel. The Appellate Body suggested – this time expressly - a different route by formulating the following test:

> ... we believe that panels should seek to compare the fiscal treatment of legitimately comparable income to determine whether the contested measure involves the foregoing of revenue which is 'otherwise due', in relation to the income in question. [393]

Matsushita, Schoenbaum, Mavroidis (2003: 268) consider this as the expression of the 'essence of the legal test' underlying the 'otherwise due' phrase. This 'comparative' test is based on the general principle of equality and the related prohibition of non-discrimination: similar situations must be treated in a similar way. The reference in the general introductory findings in the original proceedings to 'some kind of comparison' between *revenues* due under the contested measure and those that would be due in some other situation, [394] is specified by requiring a comparison between the fiscal treatment of comparable *incomes*. Interestingly, a similar approach has been recently taken by the Court of Justice which, with respect to an energy tax, noted that:

> [t]he only question to be determined is whether, under a particular statutory scheme, a State measure is such as to favour [certain undertakings] ... in comparison with other undertakings which are in a legal and factual situation that is comparable in the light of the objective pursued by the measure in question. [395]

The comparative test is an attempt to combine two aims: the *overcoming of the inadequacy of the 'but for' test* and the *reluctance to fully accept a derogation test* based, as it is, on the identification of general rules and exceptions.

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[393] Appellate Body, *US - FSC (Article 21.5 EC)*, paragraph 91.
[394] Appellate Body, *US - FSC*, paragraph 90
[395] Case C-143/99, paragraph 41.

On the one hand, the Appellate Body intends to design a flexible test which certainly gives more importance to the *substance* of the tax system rather than to its *form*, and arguably gets over the insufficiencies of the 'but for' test (and especially the risks of a too formalistic and mechanical interpretation). [396] By requiring the comparative analysis of comparable situations the new test aims to assess the measure in question closely and to consider its position within the tax system.

At the same time, however, the Appellate Body does not seem willing to fully endorse the derogation test. The expressed reason for this reluctance lies in the inevitable complexities of the quest for general rules and exceptions. [397] The Geneva-based body noted:

> [w]e do not ... consider that Article 1.1(a)(1)(ii) always *requires* panels to identify, with respect to any particular income, the "general" rule of taxation prevailing in a Member. Given the variety and complexity of domestic tax systems, it will usually be very difficult to isolate a "general" rule of taxation and "exceptions" to that "general" rule. [398]

Despite proposing the comparative test as an alternative, the Appellate Body does not provide much guidance with respect to the *criteria* to follow in the complex and flexible assessment of comparable situations. [399] No guideline is given regarding the factors (that is the factual and legal common denominators) that permit to consider two *situations* as *comparable*, or those to be taken into account when it has to be determined whether there is an *equal* or *discriminatory treatment*.

The vagueness of the comparative test (but this may well be predicated for the reasoning of all reports) might well have been intentional. [400] The motive for not developing clear tests depended on the will to avoid, in the sensitive area of taxation, the creation of findings that could be viewed as precedents applicable to

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[396] Appellate Body, *US - FSC*, paragraph 91.
[397] Appellate Body, *US - FSC (Article 21.5 EC)* paragraph 91.
[398] Ibid.
[399] Cf Appellate Body, *US - FSC (Article 21.5 EC)*, footnote 66 to paragraph 91, where it was recognised that this assessment requires a certain degree of flexibility. The Appellate Body gives just two examples by saying that it might not be appropriate to compare taxation for sales income with taxation of employment income (paragraph 90), or taxation in the hands of a domestic corporation with taxation of income in the hands of a foreign corporation (paragraph 92).
[400] Hudec (2003: 200 and 201, cf also 197).

the countless tax systems that were not subject to scrutiny, and thus to allow more flexibility in the future. This reservation of flexibility, however, coincides with a lack of direction which inevitably perpetuates the uncertainty of the advantage analysis in this field.

***Déjà-vu: is the comparative test really alternative to the derogation test?***

What should now be asked is whether the comparative test is really alternative to the derogation test, or whether we are in fact confronted with the same substance in a different shape. The reader might have a déjà-vu since this issue has been briefly addressed in the introductory section already.

While stopping short of expressly accepting the derogation test, the writer's proposition is that the Appellate Body has inevitably pointed out towards that direction.

The comparative test requires the comparison between comparable situations. The goal is clearly to determine whether comparable situations are treated similarly or not. The derogation test enquires whether the measure at issue is in line with the appropriate general rule or deviates from it. Now, there is a clear *link* between these two tests since a *general rule* is such insofar as it applies to *all comparable situations.* Although the two tests seem to share the same mechanics, they interestingly emphasise different steps of the analysis. The comparative test is clearer in defining the appropriate benchmark, that is the norm that is applicable to comparable situations. The assessment of the (equal or otherwise) treatment of comparable situations is more directly expressed by the derogation test which highlights that the logical process to establish an advantage is whether a deviation from the appropriate norm has occurred.

The difference in emphasis in the two tests corresponds to a different contribution to the clarification of the working of the advantage analysis. Eventually, the objective and the substance are the same, ie the search of whether the measure at issue is an exception to what can be viewed as the relevant general rule. It is useful to refer again to the observations of Professor Hudec who noted that

> [the] unstated assumption [would be] that a tax law governing a 'legitimately comparable' kind of income gives some indication of how the exempt income itself would have been treated, especially if that tax law happened to be a general rule or 'prevailing standard'. In other words, looking at the treatment of comparable income could have been a back-door way of looking at how the tax-exempt income itself would have been treated under the general principles of the defendant's tax law. [401]

The author then cleverly concluded that

> [i]n effect, this would be a back-door version of the 'but for' test, one that could not be blocked by tax laws that try to sever all formal links between the subsidy and the applicable general principles of the defendant's tax systems'. [402]

In conclusion, it seems that we are in the end always confronted with the task of *identifying the general rule* and *determine* whether the measure at issue is *in line or deviates from it.* Although the Appellate Body tried to distance its comparative test from the identification of general rules and exceptions, quite ironically, the specific contribution of its formulation is *exactly* to indicate how to define a general norm (and consequently to anchor any test to the latter). Once the benchmark is identified, the process is to determine whether the Member State is *discriminating* between comparable situations (comparative test version), or is *deviating* from the appropriate general rule (derogation test version). Although the substance is the same, it is the derogation test that is more determined in indicating the underlying logical process of the advantage analysis.

The heart of the advantage analysis is the idea that, once a country has adopted a certain rule or regime in its tax legislation, it should not be allowed to amend it and to introduce exceptions to favour certain undertakings when such need arises. [403] The distinction and interplay between what is norm and what is exception corresponds to the 'common sense' idea of subsidy and captures the sense of

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[401] Hudec (2003: 198).
[402] Ibid.
[403] Cf Hudec (2003: 191).

advantage which any subsidy should confer. As Professor Hudec (2003: 191) noted, the derogation from rules based on general principles may be felt as a particularly sharp 'departure from existing tax policy' and thus involve a 'more tangible sense of gain to a taxpayer'.

## Some applications

The implications of the findings of the *FSC* case study are now considered through the analysis of two issues, one concerning Member States' sovereignty in tax matters (and its constraints), the other the role played by the objectives in the derogation test.

### *The share of sovereignty in tax matters: foreign economic processes and local taxation*

The subject of this paragraph is the analysis of two cases that should not be considered as involving the 'foregoing of revenue of revenue otherwise due', and hence as conferring an advantage, because they are based on a similar rationale concerning the *share of sovereignty* in tax matters. Using the derogation test jargon, they both seem to represent *general rules or principles.*

#### *The taxation of foreign economic processes*

The first case focuses on an issue that emerges from the *FSC* dispute, ie the status under WTO subsidy rules of the taxation of foreign economic processes.

##### Territorial and world-wide taxation: economic and legal considerations

A tax system may operate on the basis of two different principles. It adopts a principle of *territoriality* if it taxes all income earned (by residents and non-residents) in its territory. Accordingly, income earned outside the country's territory is not taxed, and no more than a 'token' tax is imposed on the proceeds of such foreign earnings when they are remitted to the home country. Many European countries

adopt a principle of territoriality in their tax law systems. In the context of multinational groups, the beneficial effects of the limited scope of application of territorial tax systems may be maximised if investment is made in low-tax jurisdictions and if transfer pricing is used to shift as much income as possible to those countries.

Conversely, a tax system operates under the *world-wide* principle if it taxes all world-wide income earned by residents. The US adopts such a system by taxing all income earned by US corporations irrespective of whether that income has been earned in the US jurisdiction or abroad. Moreover, it also taxes all income that, although not produced by residents, is 'effectively connected with the conduct of a trade or business within the United States'. [404]

From an *economic* perspective, the wider scope of application of world-wide systems, with the connected disincentive to exploit the opportunities of low-tax jurisdictions, seems to involve that US groups comparatively face a handicap if compared with EC groups in their international activities. It is allegedly to tackle this disadvantage that the US introduced the *DISC* legislation first and the *FSC/ETI* legislation afterwards by exempting from taxation a portion of foreign trade income related to exports.

As emerged from the *DISC* and *US - FSC* disputes, however, the situation is different *legally*. Exemptions of portions of foreign trade income are not consistent with the GATT/WTO subsidy rules *inasmuch as* they derogate from the otherwise prevailing rule of taxation. As far as the definition of subsidy is concerned, it is immaterial that the derogation concerns export-related income, foreign income unconnected to exports, or domestic income. The crucial factor is that there is an exemption from the general tax system adopted by the Member State.

The Appellate Body made it clear that if the general policy decision is to tax all foreign source income (see the world-wide principle), Members are not permitted to carve out an exemption from the system. Once they have made their 'sovereign choice' with respect to the general features of their tax system (it is repeatedly said

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[404] S. 882(a) Internal Revenue Code (IRC).

that Members are sovereign to shape their tax systems as they wish), they are subject to the obligations under WTO law, and in particular the SCM Agreement. [405]

By contrast, it may well be argued that the decision to exclude from taxation all foreign source income should not be regarded as a subsidy. The issue was not under the examination of the Dispute Settlement Body in the *FSC* case and, to be sure, the Panel underlined that its findings should not have been taken as a suggestion that other systems of taxation, and in particular the territoriality principle, were consistent with WTO subsidy rules. [406]

This issue has however been subject to litigation in the *Tax legislation cases*, and in particular in the counter-complaints filed by the *US* against *Belgium*, *France* and *The Netherlands*. The Panels eventually condemned these laws on the premise that they exempted processes originating in the country. These conclusions were however harshly criticised and were reversed by the 1981 Understanding which accepted the lawfulness of tax exemptions concerning 'economic processes located outside the territorial limits of the exporting country' (and introduced, at the same time, the requirement of the compliance with arm's length pricing to avoid possible abuses).

The common interpretation of this understanding, which reflected the wide consensus of GATT Members on the issue, [407] is that it expressly authorised the effect of territorial tax systems and that, quite probably, it also had to be interpreted as precluding more limited tax exemptions such as those provided by *DISC* or *FSC* measures.

Both the Panel and the Appellate Body eventually concluded that, although in principle as a 'decision' under Article XVI(1) WTO the 1981 Understanding could provide guidance, this was not the case because of the fundamental differences between Article XVI:4 GATT (which was interpreted by the Understanding) on the one hand and the discipline on export subsidies of the SCM Agreement on the other hand. [408]

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[405] Matsushita, Schoenbaum, Mavroidis (2002: 272).
[406] Paragraph 7.123. Both the Panel (paragraph 7.122) and the Appellate Body (paragraph 179) generally noted that it is not the choice of a given system of taxation as such – be it world-wide or territorial – which is under scrutiny but the compliance of its rules with WTO obligations.
[407] Hudec (1993: 92).
[408] Panel, paragraph 7.79-7.85; Appellate Body, paragraphs 104-119.

Although, strictly speaking, this may be true, it is here argued that the significance of this decision for the sake of the current analysis depends on the fact that it reflected the *wide consensus* of GATT Members on what principles of international taxation may be legitimate (and, probably, also those that are not legitimate). In the writer's view, it accordingly offers an important indication of the characterisation of the principle of territoriality under subsidy rules.

We can now attempt to explain the difference in *legal* treatment between two practices that apparently lead to the same *economic* effects. [409]

What can be suggested is that the exclusion from taxation of all income earned abroad inevitably deriving from the principle of territoriality should not constitute the 'foregoing of revenue otherwise due' because, unlike the *FSC* and *ETI* mechanisms which were based on pronouncedly targeted exemptions to an extensive principle of world-wide taxation, it represents a clearer and, most importantly, *definite* choice with respect to the general scope of application of the tax system, one that seems to correspond to both a *neutral* and *convenient* share of competence in international taxation.

Border tax adjustments: a confirmation

This point becomes in our view particularly clear if a parallel is made with the treatment of so-called border tax adjustments ('BTAs').

Border tax adjustment rules identify which taxes may be rebated on exports and imposed on imports. [410] In this regard, an important distinction is that between taxes on undertakings (ie direct taxes) and taxes on products (ie indirect taxes and import charges). [411] Whereas it has always been clear that the exemption of direct taxes in relation to exports amounts to a subsidy (good examples in this regard are offered by the *DISC* and *FSC/ETI* litigation), [412] the situation is different with respect to the exemption or remission of taxes on products for export where a subsidy occurs only when there is over-compensation. Note 1 to Article 1.1(a)(ii)

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[409] See Hudec (2003: 188-192).
[410] Hufbauer & Erb (1984: 51). For a clear explanation of border tax adjustments see Jackson (1997: 218-221). See also Hufbauer & Erb (1984: 10-11; 51 et seq).
[411] For a definition of direct and indirect taxes cf footnote 58 of the SCM

SCM accordingly qualifies the form of financial contribution involving the foregoing of government revenue otherwise due by underlining that the exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy. [413]

The traditional consensus on the permissibility of this rule of border adjustment for indirect taxes and other import charges in the event of exportation is recognition of the principle of *destination* whereby it is deemed as appropriate that a product should be subject to taxation only in the country of importation. [414] Despite some criticism on the economic rationality of having a different treatment between indirect and direct taxes, [415] there has been no serious attempt to modify the law and, in particular, to consider as permissible also exemptions of direct taxation in relation to exports. [416]

The writer has suggested that the general tax exclusion of foreign-source trade is not a subsidy because it seems to depend on an acceptable sovereign choice in international tax matters that involves a *permanent* (and convenient) share of competence.

It is now argued that the functioning of territorial systems can usefully be compared with border tax adjustments.

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[412] Cf items (e) and (f) of the Illustrative List on Export Subsidies.

[413] The reference to 'duties or taxes borne by the like product' should be read as referring to final stage indirect taxes (such as value-added or sales taxes). The principle is reaffirmed in the Illustrative List on Export Subsidies and, in particular, in item (g), and also in items (h) and (i).

[414] Hufbauer & Shelton Erb (1984: 10-11) note that they BTAs rules 'permit the producer to realize approximately the "world" price for its exports and to acquire traded inputs at their "world" prices for use in export production'. Jackson (1997: 220) explains that the belief underlying BTAs rules is that the different tax burden of indirect taxes would be shifted forward to the purchaser, thus making taxation at destination appropriate. This would not apply to direct taxation which would be shifted backward to the producer.

[415] Hufbauer & Shelton Erb (1984: 54- 56), Jackson (1997: 219- 221); Matsushita, Schoenbaum and Mavroidis (2003: 479-480). The criticism is that the traditional assumption concerning the tax burden of direct/indirect taxation is not always correct with the result that a different regulation of indirect taxation (for which adjustment is possible) and direct taxation (for which it isn't) would put those countries that depend more on the latter at a disadvantage. In this regard see Tarullo (1984: 73).

[416] Before the WTO Hufbauer & Shelton Erb (1984: 62-63) suggested that the *DISC* legislation was a 'first step' towards the full acceptance of the principle of destination of border adjustments for direct taxes whereby countries could rebate all direct taxes and other social charges incurred in the production of goods for *export*, and impose those same direct taxes on *imports*.
The oddity of this suggestion is that it is difficult to *fully* juxtapose a system devised for products to undertakings. An example may help to understand the point. If a principle of world-wide taxation is adopted, what about direct taxes on the *foreign* income deriving from foreign sales which cannot however be classed as *exports* (because, for example, they are produced abroad)?

While subjecting to taxation the income earned in the territory, the principle of territoriality exempts (in principle without any exception) all foreign-source income. This seems to parallel the logic of competence allocation in tax matters that underlies the rule of border tax adjustment. The outcome is that, in the case of an international activity, only one country, and the one where the taxable activity takes place, is competent to tax. It is not argued here that this result is the most efficient from an economic perspective, but that it may represent, as border adjustments rules for indirect taxes, a reasonably satisfactory outcome. [417]

The fact remains that, from a legal perspective, the neutrality implied in the strict adherence to a territoriality approach, which defines the international competence in direct taxation in a clear and permanent way, is more likely to be consistent with WTO subsidy rules in comparison with the endorsement of a more extensive world-wide principle which is then adjusted with more or less comprehensive exemptions that progressively redefine the boundaries of the said competence to the advantage of some undertakings or sectors.

If the above is correct the ultimate finding would be that subsidy rules *do* introduce a significant *constraint* on the often repeated sovereignty of Members in tax matters by creating an incentive to adopt territorial approach and, conversely, a deterrent towards a world-wide principle of taxation.

*Local taxation*

An additional confirmation of the previous reading of the legal status of taxation of foreign income is offered by the treatment of so-called local taxation.

The starting point of the analysis is Article 2 SCM which defines the requirement of specificity, ie that a subsidy must be 'specific to an enterprise or industry or group of enterprises or industries within the jurisdiction of the granting authority'.

Article 2.2 provides that 'a subsidy which is limited to certain enterprises located within a designated geographical region within the jurisdiction of the granting

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[417] As regards BTAs, Jackson (1997: 221) underlines that 'perhaps the present rule is as good a rough approximation of equity as can be found, and it is at least administrable'. See also Matsushita, Schoenbaum and Mavroidis (2003: 480).

authority shall be specific'. The same provision hastens to add that 'it is understood that the setting or change of generally applicable tax rates by all levels of government entitled to do so shall not be deemed to be a specific subsidy for the purposes of this Agreement'.

Although this provision is set in the context of the specificity analysis, it is argued that it has *more* significance with respect to the advantage analysis because it represents an example of a measure that *does not confer an advantage in the first place.* This is again an example of the intriguing interplay between specificity and advantage analysis, which has recurred several times so far and is thoroughly addressed below.

A *local* tax measure adopted by a *local* authority which extends to all undertakings in the relevant *local* jurisdiction does not confer any advantage at all because it derives from one of the main general features of the *constitutional system* of the Member State at issue. In other words, the measure does not constitute an exception but rather a general tax measure which is the expression of a *general constitutional rule.*

*The analogy between international and local taxation under subsidy rules*

If we now juxtapose the treatment of international and local taxation under subsidy rules we can find an interesting analogy.

The exclusion from taxation of all foreign economic processes and the competence of local authorities to impose and collect taxes seem to represent two sides of the same coin. They are both examples of a share of (international and internal) tax sovereignty that is held to be – for practical, political and legal reasons - *proper* under subsidy rules. This substantially depends on the fact that these arrangements can be considered both *general* and *permanent.*

**Derogation test and objectives: a preview of the scope/justification debate**

The aim of this paragraph is to provide the reader with a brief analysis of a crucial issue which is discussed at length in the context of EC law and whose findings are fully applicable in WTO as well.

The core of the advantage analysis underlying the 'otherwise due' phrase is to determine whether the measure at issue constitutes discrimination or, better, derogation with respect to the appropriate general tax rule. This has been dubbed as the 'derogation test'.

In tax law, we have many situations which are treated differently. Now, the crucial issue is that, in order to determine whether this differential treatment does in fact constitute a derogation and hence an advantage, it is necessary to analyse the *objectives* of the tax measure and/or of the tax system.

Like any public measure, any tax may pursue various objectives. In the context of the advantage analysis, what is fundamental is to *distinguish* between objectives. As the EC experience shows, this is a difficult but crucial exercise. The presence of an objective that is in line with the *logic of the tax or the tax system* excludes that any advantage element from the differential treatment. This is not the case for those objectives that are *externally* assigned to the tax, ie are not directly linked to the purpose of the tax and/or the tax system, but rather *pursue different policy objectives.*

This distinction between *internal* and *external* objective is the fundamental divide to determine whether a tax measure which provides for a differential treatment is ultimately a tax subsidy or not. Further, it is crucial to correctly approach the recurring problem of the distinction between scope and justification.

An interesting example of measures that do not imply the 'foregoing of revenue otherwise due', because any apparent differential treatment is in fact justified by the logic of taxation, is that of technical rules.

Normally, these rules do not confer any advantage because, borrowing from an EC law jargon, they define the *parameters* of the general tax system. In the last analysis, the issue is whether the measure is in line or not with the *inherent* logic of the system. Most of these measures are accordingly justified by the need to shape the system in

accordance with generally acknowledged principles, such as that whereby a tax should accord to the 'ability to pay' of the taxpayer.

As reported by the *US – FSC* Panel (at paragraph 4.591), clearly drawing from the internal State aid law experience, the EC was arguing that determination of general tax rates, depreciation rules and rules on loss carry-overs, are a clear applications of this principle. Admittedly, the same conclusion should be reached with respect to rules to prevent tax avoidance or double taxation, provided that these measures merely address these goals and do not provide any advantage to certain categories of undertakings.

An interesting example is that of the rules aimed at preventing double taxation. Footnote 59 to the Illustrative List on Export Subsidies provides that 'paragraph (e) is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member'. Although this provision merely exclude that the conduct at issue be considered as an export subsidy, it may well be argued that, if the measure at issue does not confer an advantage, it should be considered as *not* being a *subsidy* in the first place.

The writer believes it important to repeat the point of the importance of this exercise of identification and distinction of the objectives of the tax measure and system when carrying out the advantage analysis of a tax measure. This eventually depends on the proper definition of the relation between what is scope and what is justification under subsidy rules.

The previous analysis has certainly brought to the attentive reader's mind an intriguingly similar debate in another area of GATT/WTO law, that of the rule of national treatment with respect to internal taxation and regulation. Reference is made the 'aims-and-effect' controversy, is whether the role of the objectives pursued by the measure should be taken into account when determining whether two products are 'like' under Article III: 2 or 4 GATT, or whether there is 'less favourable treatment' under Article III: 4 GATT, or rather whether any such objective should only be considered at the subsequent stage of the general

exceptions under Article XX GATT. [418] Time and space constraints preclude a more in-depth, and certainly fruitful, analysis of the issue and indeed a comparison with the 'objective – scope/justification' debate in the context of subsidy rules. This item will certainly be put on the future research agenda.

This paragraph has been entitled as 'a preview of the scope/justification debate'. The underlying intention was two-fold. At a very simplistic level, the writer just wanted to give a flavour of an important debate which is fully present in the EC context. A more prophetic meaning of the word preview is that it is only a matter of time before these issues about objectives and their distinction, and the underlying interplay between scope and justification, with respect to tax measures will be debated before the Dispute Settlement Body.

## Regulatory measures

The previous chapter has shown that, under certain conditions, also regulatory measures may be covered by the SCM Agreement since they constitute a form of financial contribution or of income/price support.

Thus, for instance, the non-applicability of collective labour agreements and minimum wage levels might be covered by subparagraph (ii) insofar as it might involve a loss of government revenue in the form of social contributions. The imposition of minimum prices might, by contrast, be covered by subparagraph (iv), as it might be the result of an order or entrustment to a private party to transfer funds, or by Article 1.1(a)(2), being an income or price support.

In these cases, since the governmental conduct is by definition non-economic, the advantage analysis should be carried out by using the derogation test. The measure will be held to confer an advantage if it derogates from the appropriate general rule.

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[418] In the WTO era, the main disputes that have resurrected the 'aims-and-effect' debate are *Japan – Taxes*, *Chile – Taxes* and *EC – Asbestos*. The scholarship has perused these cases and approached the overall issue very attentively. For an excellent overview see Trebilcock and Howse (2005: chapter 3). See also the classic paper of Hudec (1998); Verhhoessel (2002); Horn and Weiler (2003); Regan (2003); Roessler (2003); Porges and Tracthman (2003).

## Public goods

The conceptual debate on public goods and their current redefinition has been analysed at length previously.

In this section, the assumption is that we are indeed confronted with a true public good since there is a market failure which makes the provision of the relevant good or service non-economic and justifies the public intervention.

The most important example of public goods which may be covered by the SCM Agreement is that of some infrastructure and, probably, also of the relevant services.

It has been seen that the third subparagraph of Article 1.1(a)(1) SCM provides that there is a financial contribution when 'a government provides goods or services *other than general infrastructure*, or purchase goods'.

As happened with subparagraph (ii), this provision offers interesting indications with respect to the advantage analysis. In the section on economic activity, two possible readings of the term 'general' have been given.

The prevailing line of interpretation is that the exclusion of 'general infrastructure' is in fact pleonastic since it wouldn't do but repeat what is already said under Article 2 and its specificity test. 'General' would underline that infrastructures that are not be specific in their application, ie that do not apply to the exclusive advantage of a certain undertakings.

The writer has advanced an alternative reading of the phrase. The suggestion is that the term 'general' would refer to the fact that the provision relevant of the infrastructure (and service) falls within the *general infrastructure policy* of the government. Consequently, the conduct is general inasmuch as it is not derogatory from this policy.

In the context of the advantage analysis, it is therefore crucial to properly define the benchmark, in particular the meaning of 'general infrastructure policy'.

In this regard, a crucial role is played by the proper identification of the *plan* of the government with respect to infrastructures and their relevant services.

Two brief remarks can be made.

Should the infrastructural plan be viewed in a *static* or *dynamic* way?

There is indeed a risk in referring only to the *existing* plans only, that of creating an obstacle to the country's infrastructure development. It can thus be advanced that his criterion should be viewed in a *prospective* way. From another perspective, the government concerned is certainly entitled to update and improve its general infrastructure policy without its generality being defeated.

It is clear that the issue becomes very much a question of evidence. Although its determination is not always easy, the (express or inferred) *intention* of the government may play a role in this context by clarifying whether the government's plan is truly characterized by a general and neutral aim or rather aims to provide a more specific favour.

At the other side of the spectrum there is also another issue: how far can this flexible approach to the definition of general infrastructural policy go? Is there any risk that the interpreter is actually led to *impose* its view of what a general infrastructure policy should be?

The previous examination has just drawn a sketch but has certainly shown that the determination of whether the provision of an infrastructure or service is general or not is far from an easy exercise.

## The advantage analysis under the Agreement on Agriculture

As regards the Agreement on Agriculture, there seems to be little doubt that regulatory measures may indeed be covered by some of those provisions, such as Article 9.1(c) which generally refers to 'payments financed by virtue of governmental action'.

The Agreement on Agriculture does not contain a definition of the term subsidy. Although the Appellate Body drew, as context, upon the definition of subsidy in Article 1.1 SCM, [419] as we have seen in the previous chapter, Article 9.1 seems to regulate forms of (export) subsidy that cannot be limited to those fulfilling the requirements of financial contribution under Article 1.1 SCM.

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[419] Appellate Body, *Canada - Dairy*, paragraph 87; Appellate Body, *US - FSC*, paragraph 136.

The contextual interpretation under Article 1.1 SCM may however be useful with respect to the determination of whether a benefit exists. In this regard the Appellate Body has drawn inspiration from the market [420] and non-market benchmarks [421] as construed under the SCM Agreement.

There are no reasons for reaching a different conclusion with respect to those regulatory measures which *are not* covered by one of the forms of financial contribution under Article 1.1 SCM and which may nonetheless fall within the scope of the AoA.

With respect to the crucial issue of the advantage analysis, since we are talking of a regulatory conduct, the test should be the usual *derogation* one.

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[420] Appellate Body, *Canada - Dairy*, paragraph 87.
[421] Appellate Body, *US - FSC*, paragraph 140.

# 2. EC law

## Tax measures

This section examines test and benchmarks used in EC law to determine whether a tax measure confers an advantage. The difference with respect to WTO law is that the fact that the assessment rests on a *derogation test* (ie on a derogation from the general rule or norm) is virtually undisputed in EC law. The emphasis of the analysis thus inevitably shifts towards the *operation* of the test in this area and to its problems.

### The derogation test in taxation

The essence of the advantage analysis lies in the idea, a true paradigm, that a State aid involves a 'derogation from the appropriate norm'. When the government activity is economic the appropriate norm is the market and the test is whether the conduct is in line or not with *market rules.* If the government acts *qua* public authority, for example by imposing taxes, the test is whether the government derogates from the *general rule* otherwise applicable in the relevant field.

Both the Commission and the Court have endorsed this approach.

Expressly drawing inspiration from the OECD's definition of 'tax expenditure' as 'a departure from the generally accepted or benchmark tax structure, which produces a favourable tax treatment of particular types of activities or groups of taxpayers', the Commission clarified the relevant test on various occasions which consistently emphasise the ideas of normality and derogation therefrom. In the 1998 Notice on Direct Taxation we find that 'the measure must confer on recipients an advantage which relieves them of charges that are *normally* borne from their budgets' (paragraph 9, emphasis added). Even more explicitly, the 2004 Report reads:

> to determine whether a tax scheme *derogating* from the *normal* system may constitute state aid, it must be established whether the resulting tax burden is

> lower than that which would have resulted from the application of the *relevant* Member State's *normal* taxation method. [422]

The Court has consistently referred to the idea of derogation since its very early decisions. Two classic examples, which are endlessly repeated in the case-law, can be cited. The first is the seminal 1961 decision in Case 30/59 *Steenkolenmijnen* which includes the oldest case law definition of aid, and which unmistakably links the notion of aid to the existence of a derogation from the normal course. [423]

The Court laid down the more elaborate definition of the derogation test - a veritable standard - in 1974:

> the partial reduction of social charges pertaining to family allowances devolving upon employers in the textile sector is a measure intended partially to exempt undertakings of a particular industrial sector from the financial charges arising from the normal application of the general social security system, without there being any justification for this exemption on the basis of the nature or general scheme of the system'. [424]

This formulation clearly indicates the three steps of the test to determine whether there is a derogation: the identification of the general rule (the 'normal application of the general social security system'), of the differential treatment (the 'exemption' from the latter) and of the ingrained justification 'on the basis of the nature or general scheme of the system'.

The broad acceptance of the derogation test with respect to governmental taxation does not mean that there is no variety of views surrounding it.

Sometimes, far from being regarded as the *core* of the advantage analysis, as it is submitted here, it is seen as an *additional* requirement to the notion of State aid, that is independent from the advantage element. [425] Most interestingly, both practice and case law consistently consider it as part of or in any event together with the

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[422] Box 1, page 6, emphasis added.
[423] A full quotation of the relevant finding can be found in the introductory section of the chapter.
[424] Case 173/73 *Italy* v *Commission*, paragraph 15.
[425] See Bacon (1997: 297).

specificity test, confusing, in the writer's view, two steps of the analysis – advantage and specificity – which conceptually should be kept separate.

Despite these nuances, the citizenship of the test in the form of *derogation from the appropriate general tax rule* is unanimously acknowledged in EC law. Before concentrating on the operation of the derogation test which, like its application in the field of economic activities, present its own complexities, it is first necessary to fully analyse a conceptual and methodological problem concerning its proper location in the context of the advantage analysis.

**A conceptual gloss: advantage analysis, derogation test and specificity**

The derogation test (and in particular the justification of the differential treatment on the basis of the inherent logic of the system) is often considered in the context of the specificity analysis. More generally, the advantage analysis itself is often not clearly distinguished from the specificity test.

The examples are copious in the practice, case law and literature. In the Notice on Direct Taxation, the Commission noted that the

> selective nature of a measure may be justified by the "nature or general scheme of the system" [426]

The Court recently found that

> a measure which, although conferring an advantage on its recipient, is justified by the nature or general scheme of the system of which it is part does not fulfil that [?!] condition of selectivity. [427]

Along these lines, the scholarship recently observed that, where the State is 'acting in the exercise of public powers, such as in the areas of taxation, social security, etc',

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[426] Paragraph 12.
[427] Case C-143/99 *Adria-Wien*, paragraph 41. The punctuations mark are of the writer.

the test which should be used to establish the existence of a State aid is whether the measure is "selective" or "specific" (sic!). [428]

As has already been repeated many times, this confusion may derive from the ambiguity of the word 'general' which is used in the context of both advantage and specificity analysis. A measure may be considered general because it *objectively* represents the norm in the relevant field (and thus be opposed to the concept of 'exceptional'). From the perspective of its *subjective* application, a measure is general since it does apply to every person across the board (otherwise, it would be denoted as 'specific' or 'selective'). Whereas the first meaning of general is the one relevant to the analysis of the advantage, the second pertains more directly to the specificity test.

It is however important to keep the two levels of analysis separate as they address fundamentally different questions.

The derogation test, based as it is on the assessment of general rules and exceptions, aims to determine whether the measure at issue departs from the relevant benchmark and thus confers an advantage. As will be explained, the analysis of whether any differential impact of the measure is justified by the 'nature' or 'scheme' of the 'general system' is an integral part of this test. The specificity test, in contrast, focuses on the different issue of whether that measure – which grants an advantage - applies selectively, that is whether it is specific to certain undertakings.

Admittedly, in practice, in most of the cases the fact that the measure confers an advantage and is specific are two sides of the same coin since it is clear that a measure satisfies at the same time both requirements. A possible practical overlap does not however justify an ongoing conceptual confusion, if not a conflation.

This is particularly so if, even in practice, there may be measures that confer an advantage but are not specific in their application, and measures that, conversely, are specific but do not confer an advantage. A couple of examples may illustrate this possibility.

Example 1. A measure that introduces differential tax rates, and may consequently affect certain undertakings more than others, may well be justified in terms of the

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[428] Hansen, Van Ysendeck & Zülcke (2004: 203, note 6).

logic of the tax system, for example by the need to tackle tax avoidance. [429] Despite selective, this measure would not confer an advantage.

Example 2. A Member State may decide to reduce the tax burden related to certain production costs (such as research and development, environment, training, employment). The Commission recognises that these measures may well not be selective 'inasmuch as they apply without distinction to all firms and to the production of all goods'. [430] This does not mean, however, that they are not apt to confer an advantage on the recipient undertakings. [431] A non-specific advantage may thus be granted.

**The operation of the derogation test and the (crucial and critical) role of objectives**

The derogation test in tax law follows the usual three-step pattern. The first step is the identification of the benchmark, that is the general tax rule applicable in the case at issue. [432] In the light of the general rule, it should then be determined whether ii) there is a differential treatment in favour of the situation at issue and, crucially, iii) whether this differential treatment is in fact justified by the 'nature or general scheme of the system' thus excluding the possibility of a derogation from, or, using a different jargon, a discrimination in light of the general rule.

It should be emphasised that, far from being strictly separate and consequential, these stages are often overlapping in the analysis with the result that all three issues may influence each other.

In this regard, it is important to immediately underline that *objectives* play a *crucial* role in this complex process, particularly at the level of the definition of the general rule and of the enquiry of the justification.

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[429] See below.
[430] Notice on Direct Taxation, paragraph 13.
[431] Schön (1999: 927). Using a language that will become apparent in the following paragraphs, to target factors of production cannot be considered as pertaining to the 'ability to pay' of the taxpayer as it reflects considerations that seem to be external to the proper functioning of the tax system, that is the pursuit of the government's policy objectives. This measure does not meet the requirement of specificity but is certainly advantageous.
[432] Cf the 1998 Notice on Direct Taxation, paragraph 16.

This role is also *critical.* As the etymological origin of the word, the Greek verb *krinein*, suggests, this requires not only to judge but also *to separate.* In many areas of the law, and in various legal systems, the consideration of the objectives in order to establish whether there is a justification gives rise to a *crisis*, causing a decision and a distinction. The distinction between objectives is of fundamental importance for the construction of State aid rules too, and is linked to one of the *leitmotifs* of this thesis which is the difficult quest for a legal separation between what is covered and what is justified.

### *What a general (tax) rule is?*

Like in the WTO, the due premiss, based on the recognition of the sovereign prerogative of the Member State to decide the fundamental aspects of the domestic tax system, is that the appropriate benchmark must necessarily be found in the general tax system of the Member State. [433]

Various attempts have been made to define what constitutes a general rule.

As the WTO debate shows, this is not a matter of form or label but of substance. Clearly, however, it is not enough to say that it is necessary to go beneath the surface and assess the substance of the tax system if no principle to use in this assessment is suggested.

Some definitions view as the key factor the fact that the measure *is open to all economic agents* operating within a Member State. [434] The subjective breadth of application, however, has more to do with the concept of specificity or selectivity rather than with the conceptually different - and inner - issue of whether the measure represents the norm in the relevant field. In practice, the broadness of the application of the measure may indicate that the measure is the general norm but this circumstance is by no means conclusive. It is an answer to a different question.

Another definition seems more useful. In the *Maribel* case Advocate General La Pergola suggested that 'a measure is general when it is aimed at achieving equality

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[433] Cf Schön (1999: 923-924).
[434] This is the definition in the 1998 Notice on Direct Taxation, paragraph 13. For a similar definition see Bacon (1997: 298).

between businesses'. [435] Leaving aside the proactive tone, the idea of *equal treatment* is a valuable point of reference. It leads us back to the previous analysis of the formulations of the test of the advantage analysis based on a comparison between 'comparable or like situations' which both the Appellate Body (*US – FSC*) and the Court of Justice (*Adria-Wien*) adopted.

Taking stock of the reflections on those tests, the suggestion then was that *a general rule is one that applies to all comparable situations.*

A further effort of elaboration is now required. The ensuing proposition is that a rule is general because it consistently applies to all situations that, in the light of the *inherent objective* of that rule, should be subject to it. [436] In other words, the objective is the unifying principle underlying the general rule, the one that leads to regulate comparable situations similarly.

Having found an intellectually satisfying definition, which is embedded in the idea that the core of any general rule or system is given by its principal goal or objective, it is now necessary to make this workable.

If we move to tax law, the principal, obvious goal of any tax is to raise revenue. It is generally accepted that each tax should do so according to the *ability to pay* of the taxpayer. [437] This ability can be measured with respect to each tax by different indicators, such as income, wealth or consumption. [438] We can thus have general tax rules which respectively use *income*, *wealth*, *consumption* etc, as their defining objectives.

The main purpose of the tax may not be that of collecting revenue but rather to create a specific *incentive* or a *disincentive* to perform a certain conduct. Energy taxes, for example, have a clear objective other than raising revenue which is to disincentivize or, conversely, to incentivize activities that respectively have a more or less harmful impact on the environment. [439]

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[435] See Case C-75/97, paragraph 8 of the Opinion.
[436] This seems to be meaning of the two-stage test suggested by Nicolaides (2001: 332-335) which aim to detect both the 'revealed potential targets' and the 'revealed potential scope'.
[437] Cf Schön (1999: 925-927). See also Advocate General Stix-Häckl in Joined Cases C-128-129/03 *AEM*, paragraph 18 of the Opinion, and Joined Cases C-266/04 to C-270/04 *Nazairdis*, paragraph 52-53 of the Opinion
[438] Ibid.
[439] Renner-Loquenz (2003: 24).

The lesson is that the different objectives of the tax should be reflected in the criteria used to determine what is the general tax rule that pursue that objective and whether the measure at issue is in line with the general objective of that tax.

***What a derogation (or discrimination) is?***

*The divergence between the objectives of the measure and the general rule*

One of the most delicate step in the derogation test is the determination of whether the exemption or, with a different expression, the differential treatment flowing from the measure under scrutiny is in fact in line with the objectives of the relevant general rule. What is required is in fact a parallel between different objectives, those of the measure at hand and those of the appropriate general rule. The establishment of an advantage ultimately depends on the determination of a *divergence* (rather than a *convergence*) between them.

It must immediately be pointed out that the existence of a differential nature or impact of the measure at issue is not per se conclusive evidence that the measure at issue is derogation from the relevant general rule. The exemption may in fact be justified by the objective of the general rule.

This important point was laid down by the Court in the definition of the derogation test in the seminar *Italy* v *Commission* decision quoted above. [440] What is necessary to assess is whether the measure that introduces a differential treatment may in fact be justified 'by the nature or general scheme of the system' or, using a different language, 'by the logic of the system'. If this is the case, there would be a convergence of objectives between tax measure and general tax rule, and hence no derogation or discrimination and ultimately no advantage.

The scrutiny of the objectives of the tax measure and of the tax system seems to run counter to the consistent case law of the Court whereby the notion of aid is 'objective' [441] since Article 87 'does not distinguish between the measures of State

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[440] Case 173/73 *Italy* v *Commission*, paragraph 15.
[441] Case T-67/94 *Ladbroke* v *Commission*, paragraph 52.

intervention concerned by reference to their causes or aims but defines them in relation to their effects. [442]

Quite interestingly, it is this same *Italy* v *Commission* case that has planted the seeds of controversy by introducing the 'logic of the system' justification. On the one side, at paragraph 15, the Court says that a State aid is defined in relation to its effects and not to its causes or aims. On the other, at paragraph 33, the Court seems to acknowledge that those aims may indeed become relevant to determine whether the differentiation previously detected may in fact be justified on the basis of the nature or general scheme of the system.

The next paragraphs attempt to show that there is no contradiction between these findings which can in fact be reconciled with each other, at least at a theoretical level. The practice is another thing.

*The distinction among objectives*

The tension between the seemingly contradicting *dicta* of *Italy* v *Commission* can arguably be eased off if consideration is given to the distinction laid down by the Commission in its 1998 Notice on Direct Taxation with respect to the justification on the basis of the logic of the system (which may well apply to any type of tax and, arguably, also to any other form of 'regulatory' conduct).

It is suggested that the 'objectives which are *inherent* in the tax system itself' should be differentiated from the *'external* objectives assigned to a particular tax scheme (in particular, social or regional objectives)'. [443]

The practical implication of this *distinction* between *inherent* and *external* objectives is not spelled out expressly.

Pinto (2003: 145, 146-148) argue that there would be no practical impact and all objectives should be treated similarly in the 'logic of the system' exercise. [444] It seems however clear to the writer that this distinction must have consequences.

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[442] Case 173/73 *Italy* v *Commission*, paragraph 13.
[443] 1998 Notice on Direct Taxation, paragraph 26 (emphasis added).
[444] On account of the fact that 'this distinction is not made workable in practice by identifying practical criteria', this author eventually finds that the logic of the system should be assessed by taking into consideration the 'policy objectives' of the measure, be they internal or external.

The only plausible explanation for it is that only measures that pursue objectives inherent in the tax system should be justified on the basis of its logic whereas objectives externally assigned to the system should not be considered when it is necessary to determine whether the measure constitutes a State aid.

Some direction on the objectives that are inherent in the tax system is found in the 1998 Notice on Direct Taxation where the Commission specifies when the justification on the basis of the nature or general scheme of the system applies. The measure would be justified when 'exceptions to the system or differentiations within that system ... *derive directly from the basic or guiding principles of the tax system*' or where the 'economic rationale' of the measures 'makes them *necessary to functioning or effectiveness of the tax system*'. [445]

Other interpretative efforts can be found in the scholarship. For example, Bacon (1997: 301) underlines that certain rules would be in line with the logic of the tax system since they define its 'parameters'. Schön (1999: 926) suggests that only those objectives that relate to the 'structural component' of the tax and are accordingly necessary to implement its fundamental structure are inherent in the tax system, and may thus be used as justification. By contrast, the objectives that are externally assigned to a tax concern the 'tax expenditure component' which consist of the provisions by which government spending objectives are carried out through the tax system.

### *'Navigating between the poles': the risk of conflating scope and justification*

The system of State aid control in the EC seems to revolve around *two poles*. Each one has its own *substantive*, *procedural*, *institutional* and *constitutional* characteristics.

The first pole is represented by Article 87(1) EC. From the substantive point of view, it can safely be assumed that this provision is based on an *essentially technical and objective analysis*, aimed at capturing those deviations from the general norm that are liable to confer an economic advantage on certain undertakings and thereby distort competition across the border. The 'human' factor is there, as the analysis of the

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[445] 1998 Notice on Direct Taxation, paragraphs 16 and 23 (emphasis added).

complexities and criticisms of the market paradigm has clearly shown. But, the imprinting seems to be substantially denoted by an inevitable *objectivity*.

The second pole is constituted by various norms, notably Articles 87(2) and (3) and Article 86(2) EC. These provisions feature a more *political, discretional* and hence *subjective* nature. Although, as the current State Aid Action Plan seem to require, this pole too is increasingly subject to more discipline and objectivity, the focus shifts from the distortions on competition to the pursuit of socio-economic objectives, be they efficiency or equity related, which by definition require *high political choices* to be made. Despite any injection of transparency, predictability and efficiency, the stamp of these rules seems to be ineludibly *subjective*.

The different operation of two poles from the substantive point of view is echoed by the *procedural*, *institutional* and *constitutional* arrangements. [446] Generally speaking, these are centred on a clear separation of roles between Member States, ie national courts, and the EC, ie the Commission. National courts may interpret the notion of State aid under Article 87(1) EC in order enforce the standstill and notification obligations under Article 88(3) EC by ordering the recovery of aid granted illegally, that is not notified and authorised by the Commission. It is only for the Commission though to assess whether the justifications under Articles 87(2) and 87(3) EC are satisfied and the measure is 'compatible with the common market'. The evaluation of the Commission, which requires a complex economic and social assessment, is *normally* considered as rather flexible. While not touching the fundamentals of this arrangement, the current modernization trend does seem to introduce a bit more of coherency and efficiency in the system. A full exposition and appraisal is however left to chapter 5.

Now, the interpreter is navigating between these two poles. To him it is of crucial importance to understand where he should direct his ship for a safe harbour. The maps at his disposal are not however always fully clear. The data on which they are based may be faulty but, more simply, it may well be that they have been badly drafted.

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[446] To fully appreciate this point an analysis of the landmark decisions in the case-law may be sufficient. See, eg, Case 730/79 *Philip Morris*; Case C-354/90 *Salmon*; Case C-39/94 *SFEI v La Poste*.

In the scholarship there seems to be agreement that the separate issues of scope (what is covered) and justification (what is permitted) should be not be conflated at the stage of the advantage analysis. [447]

Attempts to further complicate an area which is already in great need for legal certainty should not be warranted. For example, a few years ago, Bacon (1997: 305-211) suggested the idea of introducing a 'third' category whereunder a derogation from the general systems should be justified in consideration of the 'special characteristics' of the undertakings concerned with the result there would be no aid in the first place. [448]

It is submitted that, although the task of the interpreted may be at times difficult, the choice should be a black or white one. We either have a derogation or not. If these 'special characteristics' cannot be accommodated in the logic of the system, they should be considered at the level of the justifications. For the sake of transparency and legal certainty. Despite its intellectual flair, the idea of 'justifiable derogation' risks muddling the waters further with the final result that scope and justification are again unduly merged at the level of the advantage analysis.

Despite all the argumentation deployed, the distinction between inherent and external objectives is not fully sorted. Far from being (merely) conceptual, the problem is also eminently practical.

The example of English Courts is a good one. Bacon (2004: 350-351) reports the two most common errors encountered in the application of the justification on the basis of the logic of the system: first, 'to regard the general system as *the aid measure itself*, and to state that because that measure is objectively justified, or based on solid policy reasons, the measure is not aid' and, secondly, 'to import into the concept of aid the possibility of an "objective justification" analogous to that employed in the field of free movement'.

This example highlights the risk of an incorrect application of the derogation test, ie the conflation of scope and justification. With the result that the advantage may be

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[447] Cf, eg, Ross (2004); Bacon (2004); Biondi and Rubini (2005).

[448] These 'particular characteristics' would, for example, be present for the manufacturing industry, services, agriculture, fisheries, forestry, banking, insurance, oil, SMEs, special exemptions from environmental taxes for energy-intensive industries.

charged with generally public interest considerations that are in fact extraneous to its analysis. In the previous section a similar risk has been found in the assessment of the advantage of non-economic activity. This risk is however particularly high in the context of non-economic activity of governments where we are completely in the public domain.

*An assessment of the case-law*

The argument that any differential impact is inherent in the logic of the system is very attractive to governments and is often raised. However, both the Court and the Commission have been so far quite reluctant in accepting it.

In its 2004 Report on Direct Taxation, the Commission expressly indicated that it adopts a rather restrictive approach to this justification, even suggesting that it might apply only 'in exceptional circumstances'. [449]

The writer has focused particularly on the case-law. He has analysed sixteen cases, mostly recent, taken them from a broad range of factual sets in order to provide a significant sample. The aim is to provide a more detailed account of the treatment of the 'justification on the basis of the logic of the system'. This paragraph sets forth the general results. Some of the most interesting cases are analysed separately below.

The cases are grouped in three categories where both the *correctness* of the *outcome* and the *soundness* of the *reasoning* are taken into account.

a) Correct reasoning and correct outcome

In some cases the reasoning is clear and this results into a correct outcome of the case. The defence is accepted because it is clearly founded on objectives that are inherent in the system. This is the case for tax avoidance in *Gil Insurance* [450] which is analysed at length below.

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[449] See, for example, the Report on Direct Taxation, paragraph 76 and ibid, Box No 7, page 10.
[450] Case C-308/01.

Similarly, although there is no express reference to the 'logic of the system' language, essentially the same reasoning seems to underlie the positive assessment of the tax arrangements of reserves of nuclear stations in the recent *Stadtwerke* case. [451]

Arguments on the basis of the logic of the tax system are often put forward, and - albeit sometimes with a different emphasis and sometimes without an express reference to the logic argument - in general accepted, in order to justify the autonomous tax powers of regions according to their national constitutions. [452]

In other cases, although the objective may in principle qualify as inherent in the logic of the tax system, the defence is rejected because the Court subject the measure at issue to a close scrutiny with respect to its necessity and/or proportionality to reach that aim (see *MINAS*). [453] Finally, in many cases the claim is not accepted because the measure clearly pursues an external objective (see *Heiser*, [454] *Cassa di Risparmio di Firenze*, [455] *Air Liquide* [456] ).

b) Unclear reasoning but correct outcome

In other cases, although the final decision made by the Court seems correct, the reasoning leading to it raised some doubts.

The *Maribel* decision is a good example. [457] Although from the case it emerges that the main motive for this increased reduction was the higher exposition of those

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[451] Case T-92/02. Crucially, the Court was satisfied about the objective of the reserves and its proportionality. The fact that they were not 'earmarked' did not constitute an obstacle for considering them as granting an undue advantage. For two comments on this important case, one before and one after the decision, see Reich and Helios (2002); Reich (2006).

[452] See, eg, Case 248/84 *Germany* v *Commission*, paragraph 17. More recently, Cases T-127/99; T-129/99 and T-148/99 *Territorio Histórico de Álava*, paragraphs 142 and 146; Cases T-92/00 and T-103/00 *Territorio Histórico de Álava*, paragraph 57; Cases T-269/99, T-271/99 and T-272/99 *Territorio Histórico de Guipúzcoa*, paragraph 56; Cases T-346/99, T-347/99 and T-348/99 *Territorio Histórico de Álava* [2002] ECR II-4258, paragraphs 52 and 62. See also the recent Opinion of Advocate General Geelhoed in Case C-88/03 *Portugal* v *Commission*, in particular paragraphs 48 to 72.

[453] Case C-159/01, *Netherlands* v *Commission*, paragraphs 42 to 47.

[454] Case C-172/03, paragraphs 43-49; see also the Opinion of Advocate General Tizzano, paragraphs 48 and 49. See D'Ormesson and Bouin (2005) for a note.

[455] Case C-222/04, paragraph 137; see also the Opinion of Advocate General Jacobs, paragraphs 104 and 105. An interesting case note which also broadens the picture showing the interesting connections with the law on free movement is Biondi (2006).

[456] Case C-393/04. Although no defence in this regard is raised by the defending authorities, the point is analysed and dismissed by Advocate General Tizzano, paragraphs 42 and 43 of the Opinion.

[457] Case C-75/97.

industrial sectors to international competition, the Belgian government put forward a different reading.

The reduction of social contribution at issue was a 'choice of economic policy, consisting in a decision to promote the creation of jobs in industrial sectors employing mostly manual workers earning low wages owing to their low qualifications' and this particularly occurred in those sectors that were 'most affected by redundancies and restructuring'.

Interestingly, before reaching the conclusion that, on the facts of the case, the measure was in fact pursuing a different objective, the Court spent considerable energy in considering the alternative explanation.

However, the finding whereby the said reduction 'does not at first sight appear to derogate from the nature and scheme of the general system of social protection' [458] does not find in the remainder of the reasoning an intellectually satisfying explanation.

What the Court should have clearly explained – and it did not – is the alleged nexus between i) the said reduction of social contributions (which finance the social security system) and ii) the convergence of the objectives of the measure and of the social security system. In a word, what is missing in the reasoning of the Court is the explanation of the intriguing link between *social security protection* and *job creation*. In case of a positive finding, the Court should then have had to subject the measure at issue (ie the reduction of social contributions in certain sectors) to a close scrutiny in terms of necessity/proportionality to reach that concurrent aim.

In *Adria-Wien* [459] we see a similar phenomenon. Although the conclusion of the Court is sound, the reasoning does not always support it. The reader can immediately be assured that we do not have a speculative problem as complex as the one in *Maribel*. Nonetheless, again, there are some important inaccuracies.

Again, like in *Maribel*, it emerged from the file that the measure at issue, an exemption from an energy tax in favour of undertakings of the manufacturing sector, was aimed to preserve the competitiveness of that sector in the Community.

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[458] Ibid, paragraph 36.
[459] Case C-143/99, see in particular paragraphs 49 to 52.

As usual, other justifications have been put forward by the defending government. Being an energy tax, differential treatment based on ecological rationales would be a good candidate. The fact that this objective is in line with the logic of the energy tax is accepted by the Court which however underlines that, at the same time, distinctions between undertakings supplying services and undertakings supplying goods cannot be made in this regard as 'energy consumption by each of those sectors is equally damaging to the environment'.

So far so good. The Court however also addresses another argument, noting that no evidence had been produced to show that the manufacturing sector would have been disproportionally affected from the tax from the financial standpoint. The problem is that this *economic* argument seems to sit uneasily with the logic of an energy-tax, resembling much more to an objective which external to it rather than inherent in it. If so, instead of positively addressing it, the Court should have more simply dismissed it as irrelevant.

Two more recent cases (*Italy* v *Commission* and *Unicredito*) raise again the issue of what objectives may be included in the logic of the tax at issue or more generally of the overall tax system.

What was at issue was a tax exemption in favour of Italian banks. The clear aim was again to improve the competitiveness of certain undertakings, this time at a certain stage in the development of the sector. [460] The Court thus had no difficulty in dismissing the allegation.

Having found the real aim of this measure, in the same paragraph, the Court interestingly added that the tax reduction is not justified by the nature of the tax in question because 'it is not an adaptation of the general scheme to the particular characteristics of banking undertakings'. This argument, which finds support also in the Commission's quarters [461] and in part of the scholarship, [462] whereby differential measures for certain sectors (such as agriculture and fisheries, insurance, banking, oil, gas and SMEs), would be in line with the logic of the system, cannot be accepted without strong reservation.

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[460] See Case C-148/04 *Unicredito*, paragraph 51; Case C-66/02 *Italy* v *Commission*, paragraph 101.
[461] See, eg, the 1998 Notice on Direct Taxation, paragraphs 26 and 27; Report on Direct Taxation, paragraphs 32 to 42.

The writer is of the view that, in most of these cases, arguments about the 'particularities' of certain undertakings or sectors, which would put them at a disadvantage if the normal rule were applied, are simply misplaced and cannot be justified in terms of the logic of the tax at issue or, more generally, of the general tax system. [463] Normally, the proper place for take 'specificities', disadvantages and redistributive rationales into account is that of justifications.

c) Incorrect reasoning and incorrect outcome

A very recent case provides for an example – to be fair a rare one – where the Court got it wrong. An incorrect reasoning leads to and incorrect decision. External objectives are accepted as part of the logic of the tax system with the result that the measure does not constitute an aid. A good example of an incorrect decision where scope and justification are conflated is the *AEM* decision. [464]

## Some applications

We can now examine three areas which have increasingly seen a reference to the logic of the system exception, ie technical rules, local taxation and eco-taxes.

### *Technical rules*

Some rules directly reflect the ability to pay of the taxpayer. Accordingly, even though they may have a differential impact, they are held to immediately derive from the logic of the tax system and they are not considered to create any advantage.

Reference is made to technical rules, those that 'define the parameters of the system', for example by determining what a 'corporation' is for corporation tax purposes. [465] According to the Commission, other examples are those setting of the rates of taxation, those concerning depreciation of assets, loss carry-overs, and the

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[462] See, eg, Bacon (1997); Quigley (1988); id (2004); Hancher, Ottervanger, Slot (1999: para 2.32).
[463] For similar arguments see Schön (1999: 926 and 929).
[464] Cases C-128-129/03. For a commentary see Maier and Werner (2005).
[465] See Bacon (1997: 301-302).

prevention of double taxation or tax avoidance. [466] We could add those provisions that ensure tax neutrality, [467] the efficiency of tax collection (some special measures for SMEs are sometimes justified in terms of lower collection costs for the treasury), and the principle of progressiveness. These rules are generally considered as examples of measures falling within the logic of the tax system. They would be necessary to implement the fundamental structure of the relevant tax thus belonging to its 'structural component'. With an illuminating metaphor, Schön (1999: 926) has compared them to the 'fine print' of the general decision of a Member State to levy a given tax.

That is the theory. In practice, however, it may be controversial whether a provision containing a technical rule simply measures the 'ability to pay' of the taxpayer or rather provides him with a tax incentive.

For example, rather than taking into account the ordinary life of an asset, in accordance with the good commercial practice, a depreciation rule may go beyond the objective determination of the financial situation of the taxpayer, thus creating an incentive to invest in certain assets. [468] In this regard, Bacon (1997: 300) shows how accelerated depreciation rates, which allow the undertakings concerned to postpone a proportion of their tax liability and thus confer on them an advantage, may be used to created an incentive for investment in research and development, for adopting equipments serving environmental goals or serving social purposes. Another interesting case reported by Schön (1999: 927) is that of carry-back and carry-forward of losses that, although are normally used to measure the ability to pay by disregarding the artificial limits of the respective accounting periods, may become an instrument of subsidisation of risk-taking industries.

These are however policy objectives that are external to the rationale of depreciation and losses carry-back and carry-forward rules and do not belong to the logic of the tax system. These measures should be considered as aid which may be declared as compatible with the common market if they fulfil, for example, the conditions of exemption for research and development or environmental aid.

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[466] Cf 1998 Notice on Direct Taxation, paragraph 13. Cf also the Report on Direct Taxation, paragraph 16.
[467] For an interesting example see the Report on Direct Taxation, paragraph 37.
[468] Schön (1999: 927); Bacon (1997: 301). See, eg, Case T-86/96 *Hapag Løyd*, paragraph 61.

An interesting example of these difficulties concerns the setting of tax rates. Leaving aside the debate about its rationale (redistribution?), [469] the progressiveness of the tax scale is generally considered as pertaining to the logic of the tax system, the introduction of different tax rates (for reasons unrelated to tax progression) may sometimes raise some controversy. A typical example is that of eco-taxes which may provide different rates according to the more/less polluting effect.

In this regard it is useful to examine a recent case where the Court found that the adoption of a differential rate of tax on insurance contracts was not an aid because it was justified by the need to achieve an objective linked to the good functioning of the tax system, the prevention of tax avoidance.

*Gil Insurance*

In *Gil Insurance* [470] the Court was called to examine an English tax whose categorisation had already been subject to the scrutiny of the English Court of Appeal in the *Lunn Poly* case. [471] The Finance Act 1994 had introduced the Insurance Premium Tax ('IPT') on insurance contracts which was charged at a rate of 2.5 per cent (later increased to 4 per cent). That uniform rate was subsequently replaced by the Finance Act 1997 by two different rates: a standard rate of 4 per cent and a higher rate of 17.5 per cent, the latter applying to insurance contracts connected with the provision of certain services (notably domestic appliances, motor cars and travel).

The initial decision to introduce IPT and, subsequently, a higher rate for connected insurance contracts - which equalled that of VAT - was intended to counteract 'value shifting'. With this practice a low profit margin was set for the principal product (in *Gil Insurance* domestic appliances, in *Lunn Poly* holiday packages) which attracted VAT at a rate of 17.5 per cent. By contrast, a high margin was set for the

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[469] See 1998 Notice on Direct Taxation, paragraph 24. *Contra* Schön (1999: 929).

[470] Case C-308/01 *GIL Insurance.*

[471] In R v *Customs and Excise Commissioners, ex parte Lunn Poly Ltd and another* [1999] ELRev 653 the Court of Appeal concluded that the differential rates of tax on travel insurance constituted State aid under Article 87(1) EC. For a note see Bacon (1999).

connected insurance contract which was exempt from VAT, [472] and only subject to the much lower IPT rate (as said, 2.5 or 4 per cent). The end result of this price manipulation was a loss of VAT receipts for the treasury.

One of the issues before the Court in *Gil Insurance* was whether the differential rate amounted to State aid. [473] With a standard application of the derogation test, the Court accepted the justification put forward - the need to tackle tax avoidance - and concluded, at paragraph 78 of the decision, that

> ... even on assumption that the introduction of the higher rate of IPT involves an advantage for operators offering contracts subject to the standard rate, the application of the higher rate of IPT to a specific part of the insurance contracts previously subject to the standard rate must be regarded as justified by the nature and the general scheme of the national system of taxation of insurance. The IPT scheme cannot therefore be regarded as constituting an aid measure within the meaning of Article 87(1) EC. [474]

A gloss should be made to this passage. In its analysis (notably at paragraph 74), the Court had considered that, from the perspective of value shifting and the relevant price manipulation, the 'higher rate of IPT and VAT form part of an inseparable whole'. It is with this qualification in mind that the reference to the justification on the basis of the 'national system of taxation of insurance' should be understood.

*The issue of negative aid*

Another important issue that comes out from *Gil Insurance* is whether there is room within the scope of Article 87(1) EC for the concept of so-called 'negative aid'.

In other words, the question is whether the imposition of a *burden*, in the instant case in the form of a tax, on certain undertakings can amount to an aid to other

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[472] Article 13(B)(a) of the Sixth VAT Directives provides that insurance transactions are not subject to VAT. The Court reports that, as a result of this exemption, there was also a trend towards replacing service contracts for the repair and maintenance of domestic appliances (which were subject to VAT) with insurance contracts (which, as we have said, weren't).

[473] The other questions, which focused on the Sixth VAT Directive precluded the introduction of a tax such as IPT were answered in the negative.

[474] Along these lines, see the Commission 1998 Notice on Direct Taxation, paragraph 13. Cf also Bacon (1999: 388).

undertakings that are not subject to it (obviously, what is at issue here is whether such practice may confer an advantage and not whether it may be sufficiently selective).

The views differ sharply. Some, as the UK government in the case in question, [475] argue that the general definition of State aid only includes the idea of *positive* benefit. [476] Accordingly, the introduction of a *tax disincentive* can never be held to confer an advantage on non-taxable persons. [477] Considering the broad coverage of the notion of State aid in the EC others by contrast believe that there are no reasons for excluding these forms from the notion of State aid. [478] These measures undoubtedly grant an advantage on those that are not subject to the tax.

In the decision the Court did not address the point expressly (which, as seen, was raised by the UK government). At paragraph 78, quoted above, the Court considered, by way of assumption, that the introduction of the higher rate could involve an *advantage* for operators offering contracts subject to the standard rate. However, most of the other findings, which significantly echo the Opinion of the Advocate General that expressly addressed the issue and concluded in the negative, [479] seem to lend considerable support to the traditional view. [480]

Generally speaking, and considering the broad language of Article 87(1) EC (we may recall that Article 87(1) EC covers 'any aid in any form whatsoever'), the first impression is that it should not be excluded that the imposition of a burden or a disadvantage could be considered as a State aid. To put it differently: in many cases it seems indeed that advantage and disadvantage are really two sides of the same

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[475] Reported at paragraph 57 of the decision.
[476] Schön (1999: 930). See Lasok (2000) who was counsel to the UK government in the case. An additional argument that is used in support of the traditional view is that when a higher tax is imposed it would be difficult to detect a transfer of State resources. Cf Bacon (1999: 386 to 388).
[477] Schön (1999: 930).
[478] Bacon (1997: 318; id (1999: 386-388).
[479] See paragraph 51 et seq of the Opinion. Advocate General Geelhoed found the specific distortions caused by the imposition of a burden can never be regarded as the grant of aid in favour of the market participants coming under the general measure under Article 87 EC but should be tackled under Articles 96 and 97 EC. The Advocate General expressed his view also extrajudicially. See Geelhoed (2005).
[480] When considering whether the differential rate was justified by the nature of the tax, the Court underlined that the higher rate should be considered as a ***deterrent*** (to the conclusion of connected insurance contracts) and that accordingly it was ***not intended to confer an advantage*** to those operators who offer contracts subject to the standard rate (paragraph 75 of the Judgment). The standard rate did ***not constitute a derogation*** from the general system of insurance tax as it was introduced to compensate for the fact that insurance is not subject to VAT (paragraph 76 of the Judgment). These arguments were the same put forward by the Advocate General who opined that the higher rate (as any imposition of a burden) could not give rise to aid.

coin and the same measure can be construed as either providing the former or imposing the latter.

If however the theoretical framework of the derogation test is applied to the concept of negative aid, it seems that we cannot escape the following incongruous result.

Consider the case of a country that introduces two different tax rates for polluting cars (higher rate) and non-polluting cars (lower rate). Admittedly, the former could be viewed as a disincentive to use polluting vehicles, the latter as an incentive to use more environmental friendly cars.

Unless the disciplines of the two cases is perfectly the same, with the result that it is difficult to determine what is the general rule and what is the exception, two possibilities can be envisaged. On the one hand, the higher rate could be regarded as the prevailing rule and the lower rate as the exception. This is the classic example of State aid and there is no need to deploy the concept of 'negative aid'. On the other hand, the imposition of the burden, ie the higher rate, could be viewed as the derogation from the lower rate which would then constitute the *general rate.* [481] It could now be argued that it would be rather odd to consider that, although the allegedly benefited undertakings are subject to the application of the *general rule*, they should nonetheless be regarded as advantaged by the exceptional unfavourable treatment reserved to other undertakings.

***Local taxation***

A very topical example of tax rules that may be considered consistent with the logic of the tax system are those that in some jurisdictions recognise the fiscal autonomy of local authorities.

Along these lines, it would be necessary to distinguish between tax measures concerning a certain region that are instituted by central governments, which even if extending to the whole of the relevant local area would constitute a selective aid,

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[481] It should be recalled that the existence of a derogation does not necessarily mean that this is ***always favourable*** to the relevant undertakings. Once it has been established that the measure at issue deviates from the general scheme, it is still necessary to determine that this exception is advantageous.

and tax measures adopted by local authorities which extend to all undertakings within the relevant territory and would not amount to aid.

It could be asked why State aid rules should distinguish between these two situations.

Arguably, within the context of the Member State at issue, which is principally responsible for the compliance with State aid rules, even *local* taxes adopted by *local* authorities can be viewed as a differential treatment within its (ie of the Member State) jurisdiction. It could further be observed that, from the point of view of its distortive impact, there is probably no difference between whether the same tax measure is adopted at a central or local level. Aid measures with local scope produce similar effects irrespective of whether they originate and/or are funded at central or local level.

These remarks lead us to considering the commonly accepted rationale for justifying the differentiation inherent in local taxation, which is *constitutional* since it relates to the internal share of competence within the jurisdiction of the Member State in question. So far, it seems that the Court has generally accepted this principle (see the cases discussed above). A case currently pending before the Court directly addresses this issue. [482] It has sparked a lively debate – in and outside the courtroom. It will hopefully provide a comprehensive final word on the issue. For now, it offer us good food for thought (and speculation). For now we only have the Opinion of the Advocate General who underlined that true fiscal autonomy should exist only if it occurs at three levels: institutional, procedural and economical. [483] Interestingly, the Commission argues that, unless there is complete symmetry in tax autonomy within the country (which means that every local authority has the same powers), there is specificity.

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[482] Case C-88/03 *Portugal* v *Commission*. For a commentary see Nicolaides (2006).

[483] It is worth underlining that, in the WTO, McGovern (1995) argued that economical autonomy is not necessary under Article 2.2 SCM.

### *Environmental taxes*

The increasing attention to the protection of the environment has a considerable impact in shaping government's policies and laws.

Its importance is expressly sanctioned in Articles 2 and 6 EC. According to Article 174(2) EC, EC environmental law is inspired and moulded by some principles that admittedly play an important role also in the context of EC State aid regulation.

Among these principles, a particularly significance is played by the 'polluter pays' principle that requires that all environmental costs should be absorbed (internalised) in production costs. [484] As Advocate General Jacobs clearly explained, in the context of the definition of State aid under Article 87(1) EC, this principle is

> used as an analytical tool to allocate responsibility according to economic criteria for the costs entailed by the pollution in question. A given measure will constitute State aid where it relieves those liable under the polluter-pays principle from their primary responsibility to bear the costs. [485]

Other principles that could arguably play a role in the definition of State aid are the principles of precaution, prevention, and that damage should be rectified at source.

Member States increasingly make use of tax systems to pursue environmental objectives, for example by encouraging or discouraging certain activities in accordance with their impact on the environment.

In some cases these taxes, directly or indirectly, differentiate between various situations and undertakings and fall within the scrutiny of the tax and State aid provisions of the EC Treaty. [486] As regards tax rules, reference should be made to Article 90 EC. This provision prohibits discrimination with respect to internal taxation between imported and 'similar' domestic products. It further prohibits the imposition on imports of 'any taxation of such a nature as to afford indirect

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[484] The premiss is that, inasmuch as they are not internalised in production costs, environmental costs represent a so-called 'negative externality', that is a loss to society (and not to its producer). The 'polluter pays' principle aims to tackle this market failure by requiring that the producer of the damage should also bear its costs. The important role played by the 'polluter pays' principle in EC State aid law is explored by Advocate General Jacobs in his Opinion in Case C-126/01 *GEMO*, paragraphs 66 to 77.

[485] Ibid, paragraph 69.

[486] See, generally, Van Calster (2000); Facenna (2004).

protection to other products'. The reader has certainly noted the striking similarity of this provision with Article III:2 GATT, which admittedly constituted its model. It has also been seen that the debate of the role of objectives at the level of the prohibition of Article III GATT is very lively.

In the EC, it is worth mentioning the important *Outokumpu* decision [487] where the question was whether differential tax rates between domestic and imported electricity which, overall, were disadvantageous toward the latter could be justified by an environmental objective. Adopting a strict approach, the Court denied that this kind of justification be advanced at the level of Article 90 EC.

In State aid law the issue is whether the measure at issue provides for a derogation from the general scheme of the tax. As with respect to Article 90 EC, the important question here is whether any differential treatment can in fact be find a justification in the environmental logic of the tax.

The fundamental issue becomes whether the environmental objective of the tax is sufficient to define its general nature. The starting point of the analysis has already been expressed previously.

Renner-Loquenz (2003: 24) has rightly observed that energy taxes differ from the majority of other taxes because they have a *clear objective other than raising revenue.* As seen, this is an incentive/disincentive effect with respect to the environmental impact of a given activity. This lack of ambiguity with respect to the objectives pursued should make the reference to the 'logic of the system' justification easier and at the same time reduce the possibilities of abusing it.

Precious guidance can be offered by the *polluter pays principle* cited above.

The justification should be acknowledged for those tax measures that, *in line with that principle*, aim at internalising environmental costs and accordingly induce a certain environmentally-friendly conduct on the targeted undertakings. A tax shaped in this way seems also to be consistent with the principles of precaution, prevention and of rectification of environmental damage at source.

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[487] Case C-231/96.

By contrast, other differential taxes does *not* seem to be *in line with the environmental objectives* of the tax but rather to run against them. Tax concessions inserted within the environmental tax and based on economic or financial considerations seem to be *external* to the inherent logic of the tax. It is for example common to provide relief for, respectively, energy-intensive industries or undertakings using or producing recycled material. This is motivated by the fact that the normal application of the environmental tax to the relevant undertakings would be *financially too burdensome.*

Bacon (1997: 308) asked whether this relief should be regarded as not constituting aid in the first place, on the ground of the disproportionate costs borne by these industries as a consequence of the considerable use of energy and production of waste required by their production processes. The writer is not persuaded. This measure clearly constitutes a derogation from the general logic of the environmental tax since it is at odd with the 'polluter pays' principle and its disincentive effect. It therefore confers an advantage and, if all the other conditions of Article 87(1) EC are fulfilled, should be regarded as an aid, although it may be eligible for exemption under Article 87(3) EC.

It is in this light that the two recent decisions of the Court in *Adria-Wien* and *MINAS* (cited above) should be read. A differential treatment justified by the environmental objective of the tax should in principle be regarded as pertaining to the logic of the tax. What is however always necessary is to subject the measure to a close scrutiny to ascertain the necessity and proportionality towards the stated objective. A good example of this exercise is the *MINAS* decision.

## Regulatory measures

This paragraph should begin by recalling the main finding of the previous chapter. Although many regulatory measures are *potentially* covered by Article 87(1) EC, under the current state of law many of aren't. The writer has however argued that the net should be cast wider. This justifies a brief exposition of the working of the advantage analysis of regulation.

Generally speaking, this closely follows that carried out with fiscal measures. It should however be immediately anticipated that in many cases the judgment cannot be so neat. It is not fully clear whether the conduct should be classed as economic or not, and which test should thus apply.

That said, the normal test for regulation is whether the measure at issue *favourably derogates* from the general regime or rule otherwise applicable by 'lowering' the degree of regulation in the relevant case. Three cases are examined in detailed in the next brief sub-paragraphs, those concerning the (de)regulation of employment, environment and debt.

### *Deregulation of employment and environmental standards*

If the departure from the normal application of the regulation of the employment relationship involves a decrease of the level of contractual or legal protection for employees, this form of 'deregulation' necessarily confers an advantage for the relevant employers in terms of lower labour costs.

In the *Sloman Neptun* case the partial non-application of German law to foreign crews of vessels flying the German flag but enrolled with an international register meant that the ordinary collective agreement, with its pay and social security level, did not apply to the relevant employment relationships. The Court found that this measure did not constitute a grant of aid to the ship owners.

Irrespective of whether this form of public intervention should be caught by the rules, the measure at issue *did* derogate from the normal rule of German employment law and thus conferred an advantage to the relevant ship owners. That was the stated intention of the legislator, ie to provide the undertakings concerned

with a lower pay and social contributions burden. Albeit with an ambiguous language, this was also recognised by the Court (see paragraph 21).

What is interesting to ask at the level of the advantage analysis is whether this differential treatment could in fact be justified by the logic of the measure.

In this regard, the most interesting argument was put forward by Advocate General Darmon who opined that the measure at issue did not derogate from the system but 'set the limits' to the application of German Law, enabling in particular individuals faced with an 'extraneous factor' (the seafarers were non-resident) to choose the law applicable to agreements between them. An extensive comparison of the laws of other Member States was carried out to support this conclusion (cf paragraphs 86 to 96 of the Opinion). As Bacon (1997: 315-316) rightly observes, however, this exercise may be useful only in part since the benchmark of the derogation test - the general rule - should be found in the laws of the Member at issue. Upon closer scrutiny of German law, the measure at issue *did* represent a derogation from what would have applied otherwise. Quite simply, the international register was not a general system since it did not apply to all ship owners. Further, it is questionable that the fact that a differentiated protection be provided for workers on ships included in these register is a universal phenomenon. [488]

Similar observations should be made for the *Kirsammer Hack* case where the exclusion of small businesses from a legal regime requiring payment of compensation in the event of unfair dismissals was not considered an aid to the businesses concerned. As seen in chapter 2, this finding is based on arguments remarkably similar to those underlying the *Sloman Neptun* decision.

If we now concentrate on the advantage analysis it seems clear that the non-application of the normal rules on liability for unfair dismissal relieved the employers concerned of one cost normally borne by SMEs. What is interesting is to consider the justification for this derogation that the Court seems to have hinted at when it referred to the aim 'to avoid imposing on those businesses financial constraints that might hinder their development'. Advocate General Darmon heavily relied on this aspect, and in particular on the other characteristics of

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[488] See Bacon (1997: 316).

employment relationships within SMEs (such as their personal character and the 'material impossibility of being able to offer the worker another post within the same structure'), to expressly justify this measure on the basis of the logic of the tax system. [489]

Arguably however both the Court and the Advocate General got it wrong, at least with respect to the 'SME' argument.

The argument of the Advocate General seem to be beside the point. What was at issue in the case was not a provision concerning *reinstatement into the workplace* but rather providing *compensation* in the event of unlawful dismissal. Although more in line with the rationale of the measure at issue, the Court's argument, tries to prove too much. The measure at issue should be considered as a derogation from the normal law of remedies for unfair dismissal. The special problems of SMEs which would justify a limitation (or, indeed, exclusion) of compensation should not be considered at the level of the definition of aid and, in particular, of the advantage analysis, but a later stage. It is indeed known that due to the particular problems they face, and the important role played in the economy, SMEs enjoy a special treatment when the compatibility with the common market of aid measures benefiting them is under scrutiny under Article 87(3)(c) EC.

Similar remarks could be made with other cases of employment de-regulation such as *Viscido* where the Court found that the departure from the ordinary rule concerning the open duration of employment contracts, which enabled the Italian Post Office to recruit personnel on a fixed-term basis, did not constitute a State aid. Leaving aside the 'cost to government' argument, which has already been examined in the previous chapter, and concentrating on the advantage analysis, the measure clearly deviated from the ordinary rule and guaranteed to the Post Office a higher level of flexibility.

All the cases of 'employment de-regulation' examined above do confer an advantage to the undertakings concerned since they undoubtedly derogate from the applicable general rule. Importantly, the examination of the arguments based on the logic of the system shows how this justification is difficult to apply.

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[489] Cf paragraphs 64 to 67.

For the same reasons indicated with respect to tax measures, the exclusion of these measures from Article 87(1) EC seems to disrupt the proper application of State aid rules falling into the 'trap of conflation'.

Should they be covered by State aid law, similar considerations apply to the measures of deregulation of environmental standards.

Undertakings are subject to the various laws and regulation that in each jurisdiction fix certain environmental standards for carrying out certain activities. For example, a certain conduct, such as the adoption of technologies or equipments, may be required in order to lower, or indeed exclude, the emissions of polluting substances into the environment.

Environmental costs belong to the costs normally included in the budget of undertakings but the compliance with these regulations is sometimes costly. The government may therefore decide to improve the competitive position of these undertakings by 'de-regulating' these standard. Now, inasmuch as this deregulation amounts to a derogation from or exception to the general rule, the conclusion is that there is an advantage.

In the previous part of the analysis it has been seen that, economic and financial considerations concerning the financial burden of compliance with regulations, should not be considered as an appropriate justification based on the logic of the measure but rather an external objective.

***The regulation of debt***

With the expression 'regulation of debt' the writer refers to all those forms of regulation that affect the liability of an undertaking for its debts.

Before briefly examining some examples, two general remarks can immediately be made.

First, in general, the approach adopted by the Court with respect to these measures seems to show less deference towards Member States' prerogatives as compared to that concerning the cases of 'social de-regulation' analysed above.

Secondly, this is a grey area of the law from the point of view of the advantage analysis where we see an interesting conceptual interplay between what is non-economic and what is economic, and hence between what seems to be subject to a normative derogation test and what is subject to a market test.

Three main examples of forms of regulation of debt can be found from the case-law. First, we have special bankruptcy and insolvency rules that exempt certain undertakings from the ordinary regime. Secondly, there may be rules that provide an explicit guarantee or coverage of losses by the State, either unconditional or depending on certain circumstances (such as the acquisition by the State of a holding in a company which entails, in certain cases, unlimited liability). Thirdly, the conduct of the government as public creditor when its debtor is in default in the payment of taxes or social contributions.

Commencing from the first case, it seems clear, from the advantage analysis perspective, that rules that exempt certain undertakings from the ordinary bankruptcy and insolvency regime should normally be held to constitute a derogation. In its 1999 Notice on Guarantees, the Commission regards these measures as aid in the form of a guarantee (see paragraph 2.1.3).

The two main authorities in this field are *Ecotrade* and *Piaggio* where the Court held that, on condition that it entailed an additional burden for public authorities, [490] the application to large undertakings in difficulties of a system derogating from the rules of ordinary law relating to insolvency (and providing in particular the absolute prohibition of individual actions for enforcement and the suspension of interest on all debts owed by the undertakings in question, and the correlated reduction in creditors' profits) could be regarded as a State aid. [491]

The second category of forms of regulation of debt is more complex for its ambiguity. This mainly depends on two reasons, partly intertwined, the determination of the appropriate benchmark – normative or market – and the fact that in many cases what are at issues are general rules which are applicable also to private agents.

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[490] See, however, chapter 2 above for the serious ambiguity on the point – arguably a Freudian slip – of the conclusion and operative part of the relevant decisions.

With respect to those rules that provide an explicit guarantee or coverage of losses by the State, reference should be made to the German system of guarantees to publicly owned banks which ensured an open-ended guarantee against their liabilities and thereby afforded them cheaper funding. [492] After a lengthy negotiation with the Commission, which regarded these measures as a guarantee, [493] the German government agreed to phase out the system. [494]

Interestingly, it seems that the benchmark applicable to both the 'maintenance' obligation (which obliges the supporting entity to guarantee the stable economic basis of the bank) and 'guarantee' obligation (which obliges the supporting entity to guarantee the claims of creditors of the bank) is a market one. [495]

In any event, with a language which echoes a possible justification on the basis of the logic of the German (public) corporate system, Schneider (2001: 371) has argued that 'financing and liability rules are a structural element of the law of public corporations' with the result that the said obligations should not be regarded as aid.

As regards to the second case, when the acquisition by the State of a holding in a company entails, in certain cases, unlimited liability, it is necessary to mention the *IOR* and *EFIM* decisions of the Commission. The provision at issue was Article 2362 of the Italian Civil Code which provides that, in case of insolvency of a limited company, the benefit of limited liability is lost for those debts incurred when there was only one shareholder (that shareholder being thus liable for all the company's debts during his sole control). According to the Commission, when that shareholder is a public authority this unlimited liability is in effect a guarantee. [496]

This case is paradigmatic to show the ambiguity explained above. On the one hand, this is a general provision of company law applicable to any company and to any shareholder. On the other hand, the Commission thought that a public investor cannot shelter itself behind this provision and its apparent inevitability.

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[491] For a commentary on the so called 'Prodi law', and its subsequent amendments to make in EC law compliant, see Roberti (1999); Conte (1999); Cirenei (1999).
[492] A very good discussion on the complex legal problems raised by these German guarantees can be found in Ehlermann and Everson (2001: 177 et seq).
[493] See 1999 Notice on Guarantees, paragraph 2.1.3.
[494] See Thirty-First Report on Competition Law (2001: 108 and 110).
[495] See Koenig (2001: 242, 244-245).
[496] A discussion on the problems raised by Article 2362 of the Italian Civil code is present in various papers of the second part of Ehlermann and Everson (2001). See, in particular, Roberti (1999).

What should be considered is whether, on the circumstances of the case, a private investor would have reached the insolvency stage or rather, in the knowledge of its possible unlimited liability, would have taken alternative steps, such as filing liquidation. The fact remains that the presence of this rule, when applied to a public shareholder, might have distorted the functioning of the capital market by increasing the rating of the borrower.

Despite the sweeping statements in the 1993 *EFIM* Notice, and also in the 1993 Communication on Public Undertakings (paragraphs 24 and 38.2) and in the 1999 Notice on Guarantees (paragraph 2.1.3), reading the two Commission original decisions the impression is however that the *real* problem is not with the general provision of the civil code, but rather, and more appropriately, with the overall conduct taken by the public shareholder *under the cover* of that provision.

Finally, we can approach the third example of regulation of debt which occurs when the conduct of the government as public creditor when its debtor is in default in the payment of taxes or social contributions. It seems that these cases too escape from the 'non-market' area since they are consistently assessed on the basis of market criteria. The test is not that of private *investor* but rather that of a public *creditor* which, as has been explained previously, aims at recovering its credit. This distinction, which has been laid down first by Advocate General La Pergola in the *Tubacex* case, [497] has recently been reformulated in a clear fashion by Advocate General Maduro in the *Grupo de Empresas Alvarez* case. [498]

The conduct of a diligent creditor has been analysed in various cases, where the various courses of conduct of the public authority – and its possible alternatives - have been subject to close scrutiny. [499] The fact that the debt is public since it concerns tax and social contributions arrears does not seem to be relevant. The principle seems undisputed. Once the public law relationship has arisen, the public authority is on a par of a private creditor in similar circumstances. It should therefore be tested accordingly.

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[497] C-342/96.
[498] C-276/00.
[499] See, eg, C-342/96 *Tubacex*; C-480/98 *Magefesa*; C-256/97 *DMT*; C-276/02 *Grupo de Empresas Alvarez*; T-36/99 *Lenzing*. In the literature see Atanasiu (2005); Nicolaides and Kekelekis (2005); Criscuolo (1999).

Like in the previous example on Article 2362 of the Italian Civil Code, it seems however that, normally, the focus is not a given piece of legislation but rather the exercise of the conduct by the public authority. Thus, the Commission observed in *Magefesa* that what was at issue in the case was not the Spanish legislation but 'rather the systematic non-payment of certain debts'. [500]

However it is, this is another nice example of expansion of the market logic to an area of public activity.

## Public goods

This paragraph merely sums up the previous findings on the problem of definition of public goods in the context of the advantage analysis, and refer the reader to the relevant analysis.

The first important finding is that public goods are quite rare. Consequently, the relevant conduct of the public authority should normally be regarded as economic and tested against economic criteria. It is only in those cases where the provision of the good or service at issue should be considered to constitute a true public good that the conduct would be qualified as non-economic and the derogation test would apply. The analysis made previously in the context of WTO law is fully transposable here too.

[500] C-480/98, paragraph 14.

## 3. Bringing WTO law and EC law together

This section on non-economic activity and normative benchmarks has seen a great degree of convergence between the two systems.

We can briefly sum up the main findings.

First, it may be difficult to determine whether the conduct at issue is ***economic*** or ***non-economic***. There is a probably inevitable grey area (see the 'public goods' issue) where it is not clear whether the conduct is inherently public and could, even hypothetically, be carried out by the private sector. This lack of clarity leads to the ambiguity of the test – economic or normative – to actually use in the advantage analysis.

Secondly, mainly as a direct and indirect consequence of the current liberalization/privatization trend, we see an ***expansion of market logic***. Many areas which were traditionally considered public reserves are more and more open to the private, the market and its logic. Again, the example of infrastructure and public goods has been significant. But, probably, also the analysis of certain forms of so-called regulatory conduct have raised this point.

Thirdly, with respect to the application of the ***derogation test***, the intersection between the two systems in terms of language and substance has been remarkable. Whereas the identification of the actual test for non-economic activity, as the *US – FSC* dispute shows, is more accentuated in WTO law than in EC law, the subsequent difficulties in determining what is a ***general rule*** and what is an ***exception*** is a recurring theme.

Fourthly, the role of ***objectives*** to determine whether a differential treatment is in fact an exception has also proved to be an important issue (common in the EC, and, it can be predicted, *soon* common in the WTO). In this regard, the topic of the role played by the objectives of the measure shows that in both systems there is an irresistible force of ***attraction*** between ***scope*** and ***justification***. In other words, it is sometimes difficult to distinguish between what is covered by the discipline on the one hand and what is justified by the latter on the other. It has been argued,

however, that under both systems there are good – conceptual and practical - reasons for keeping the two levels separate.

In the coda of the chapter we analyse a case which intriguingly raise the question of whether we are assisting a conflation of scope and justification. The status under State aid law of public service financing has been very topical for a while. Again, it can be predicted that it has the potential of becoming so also in the WTO.

## V. Case Study on the Financing of Public Services: *Quasi*-Market Transaction or Disadvantage Compensation?

The examination of one of the most important themes of this chapter - the role of public policy objectives in the advantage analysis - may result in an interesting *coda*, ie a brief case study on the impact of State aid and subsidy rules on the financing of public services. One further reason for putting it at the end of the chapter is that it may concern both market and non-market conduct of public entities.

### 1. Public services: their mission, their problem, their relationship with State aid/subsidy rules

The provision to all citizens of certain services that present an element of *general* or *public interest* is one of the main duties of the Welfare State. [501]

This is expressly and emphatically recognised in EC law, for example in Article 16 EC, which is placed among the 'Principles' of the EC Treaty and recognises that 'services of general economic interest' belong to the 'shared values of the Union' and fulfil an important role in 'promoting social and territorial cohesion'. This special status is confirmed also in the would-be Constitution for Europe, currently under ratification process in the various Member States. [502]

The *protection of public services* is also becoming a topical issue at the international level, as it is currently demonstrated by the heated debate surrounding the impact of the international law, particularly the GATS, on their regulation at the domestic level. [503] Concerns are voiced from various quarters about the interference of international trade law, and in particular its push towards liberalization, with the safeguard of domestic prerogatives in regulating public services, and, more generally, the need to maintain certain standards of protection. Borrowing from the title of a recent

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[501] See generally Szyszczak (2001); Krajewski (2003a).

[502] See, eg, Articles II-96 and III-122.

[503] See, for example, Krajewski (2003a) where there are ample references. See also Adlung (2006); Benitah (2005); Costamagna (2005); Krajewski (2004); Munari (2004); Sinclair and Grieshaber-Otto (2002). To fully comprehend the importance of the debate, it is also useful to look at official documents. See, eg, OECD (2001b), WTO (2001), WTO and WHO (2002); UN HR Commissioner (2002); UNCTAD (2005).

much-acclaimed essay of the Nobel laureate Professor Stiglitz, this discussion is part of the wider debate on 'globalization and its discontents'. [504]

Having said that, the supply of public services is affected by an *inherent economic* problem. Their performance, particularly if certain standards of quality and accessibility have to be maintained (which, in the EC jargon, are summed up in the concept of 'universal service'), may not be viable from a financial perspective because of the *difficulty of covering the relevant costs.* [505] In other words, private actors may find it unprofitable to invest in these services, or at least to provide them at certain, required conditions. The intervention of the government to financially support the provision of these services may thus be needed, and it often (although not always) takes the shape of direct subsidisation to the suppliers. [506]

The interesting question, which has expressly come out in the EC and has recently raised a hot debate, is whether the financing of public services (which is clearly motivated by a public policy objective) should be regarded as a State aid, which could be justified by the specific provision of the EC Treaty dealing with the performance of services of general economic interest (ie Article 86(2) EC), or whether, more radically, if certain conditions – mainly of *transparency*, *proportionality* and *efficiency* - are fulfilled, it should not be held to be a State aid in the first place. This is the issue that we will deal in the first part, focussing on the recent decision of the Court of Justice in *Altmark*, and, in particular, on its impact on the *distinction between advantage analysis* and *public policy objectives assessment* that we have sketched above.

Although, in the WTO, the law of subsidies with respect to services is not as developed as that concerning goods, it is natural – not only from an academic but also from a more practical perspective - to enquire whether a similar issue can be envisaged in the context of GATS too. We will in particular analyse whether, as the law now stands, and in the context of the current Doha Round negotiations under

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[504] Stiglitz (2002). Political correctness requires citing the response to this book which came in Bhagwati (2004). Interestingly, both academics teach at Columbia University, NY.
[505] See Nicolaides (2003a) page 188.
[506] There are indeed various methods of financing public services (such as direct subsidies, grant of exclusive rights, consumer vouchers) which may be chosen by governments on the basis of the different economic and managerial impact, in particular in terms of costs and incentives, they wish to produce.

Article XV GATS, some inspiration can be drawn from the EC discussion and settlement.

## 2. The financing of public services under EC State aid rules: the *Altmark* decision

### The stakes and the clash

As we have anticipated, a lively debated has recently sparked off in the EC on whether support given by the State to enable undertakings entrusted with services of general economic interest (SGEIs or, more simply, public services) to discharge their public service obligations (PSOs) should be considered as State aid. The crux of the matter is the risk that, far from merely compensating the costs of PSOs, the recipient undertaking may redirect the resources intended to finance the SGEIs to support other activities open to competition. This was the *economic concern*. At the *political* and *legal* levels, the worries were represented by the risk of *excluding* a whole set of potentially troublesome measures of support *from the scrutiny of the Commission* on the one side and from substantially conflating the - admittedly separate - issues of *scope* and *justification* thus emptying the bifurcated system of rules provided for by the EC Treaty (Article 87(1) versus Article 86(2)).

These questions have produced a jurisprudential clash between the Community Courts and also between Advocate Generals – a true clash of the Titans –, and also a wide discussion at the political level.

For their significance for the current analysis, we will mainly concentrate on the two recent *Ferring* and *Altmark* cases, and in particular on the *findings* that are more *relevant to the issue of the role of public policy objectives in the advantage analysis*.

## The *Ferring* and *Altmark* decisions [507]

Two main approaches (*compensation approach* and *State aid approach*) have traditionally been adopted when analysing the classification of financial compensation of SGEIs under State aid law.

The *compensation approach* considers that financial assistance that merely compensates a PSO does not constitute a State aid. The underlying concept is that that financial compensation is a mere *contropartie* for the public service rendered to the extent that it matches the extra costs incurred by the operation of the SGEI. [508] Under the *State aid approach* the financial compensation of a PSO is always considered as a State aid in the first place which can then be justified under Article 86(2) EC. [509]

The Court of Justice was called to decide on the issue in *Ferring*. [510] This case dealt with tax concessions granted to wholesale distributors of medicines. These tax exemptions were made because of the specific public obligations that distributors had to bear (stocking at all times a quantity of medicines sufficient to satisfy the needs of regular customers and to deliver within a 24 hour period any medicines required to any location in their distribution area). The Court found that this exemption could be regarded as compensation for the services thus not constituting State aid. In that case, Advocate General Tizzano noted:

> the fact that such measures *do not confer any real advantage* on an undertaking entrusted with a service of general interest and therefore are not likely to alter the conditions of competition appears a decisive argument to me. ... In other words, *the imposition of the obligation* and *the provision of compensation* cannot be considered as separate matters as they are *two sides of the same public measure* which is intended, as a whole, to guarantee that public interests of primary importance are satisfied'. [511]

Thus, these measures did not confer 'any advantage' and hence could not distort competition the compensation intended to offset the additional costs of the PSO was not a State aid.

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[507] This paragraph and the next one partly draws on research already published in Biondi and Rubini (2005). The relevant parts are the result of the personal research of the writer.
[508] See Case 240/83 *ADBHU*. This approach has been followed by the Commission's subsequent practice.
[509] This has been followed by the CFI in Case T-106/95 *FFSA* and Case T-46/97 *SIC*.
[510] Case C-53/00 *Ferring*.

The *Ferring* decision has been subject to some criticism. The official critique came from the Advocate General in *Altmark*, a case that concerned the granting of licences to operate regular bus services through public subsidies.

In his two Opinions, Advocate General Léger strongly criticised *Ferring*, arguing that it was liable to undermine the structure and logic of the Treaty provisions in respect of State aid, and reaffirmed the State aid approach. [512] He put forward various arguments.

First, State aid must not be defined on the basis of its aims but of its effects. It is an objective concept which focuses on a notion of 'net' (in contrast to 'gross') aid. What matters under Article 87(1) EC is whether the measure at issue is capable of conferring a selective advantage that distorts competition and affects intra-Community trade. The compensation approach confuses two distinct legal issues, the classification of the measure as State aid and its possible justification.

Secondly, Article 86(2) would be deprived of any meaningful role in the field of State aid. If compensation would not constitute aid, over-compensation, as was expressly recognised by the Court under *Ferring*, could not be justified under Article 86(2) because it would not be proportionate.

Finally, as a result of the compensation approach, the surveillance role of the Commission in controlling measures financing public services would be diminished.

Advocate General Jacobs expressed his view in this debate in *GEMO*. [513] In his Opinion, on the issue of whether the public financing of animal carcass disposal undertakings constituted aid, he presented what has been dubbed as the '*quid pro quo* approach', or also 'differentiated compensation approach'. [514]

The Court should distinguish between two types of situations. Where there is a direct and manifest link between the State financing and clearly defined PSOs (such as a public tender procedure), the sums paid by the State would not constitute State aid under Article 87(1) EC. In his view, the financing would represent a mere

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[511] Paragraphs 60 and 61 of the Opinion (emphasis added).
[512] First Opinion delivered by Advocate General Léger on 19 March 2002 in Case C-280/00 *Altmark*. Cf also the second Opinion, delivered on 14 January 2003 as a consequence of the *Ferring* decision and the Opinion of Advocate General Jacobs in Case C-126/01 *GEMO*.
[513] Case C-126/01.
[514] Cf Nicolaides (2003a) page 196.

*contropartie* of the PSO, almost as if the government were *paying* for the public service. Where by contrast there is no such direct and manifest link or the PSOs are not clearly defined, the sums paid by the public authorities would constitute aid. [515]

The Court passed its decision in *Altmark* on 24th July 2003. [516] The question referred to the Court was whether subsidies granted by Germany to an undertaking in order to operate a regular bus service in a specific region had to be considered aid or merely a compensation for the services offered.

The Court held that such compensation did not confer an advantage for the undertaking concerned and therefore could not be considered State aid. In particular, no advantage could be established where a State financial measure must be regarded as compensation for the services provided by the recipient undertakings in order to discharge public service obligations.

However, so that such compensation does not provide any advantage, it should satisfy four conditions. First, the recipient company must have actual public service obligations to discharge and those obligations must be clearly defined. Secondly, the parameters on the basis of which the compensation is calculated must be established in advance in an objective and transparent manner. Thirdly, the compensation cannot exceed what is necessary to cover all or part of the costs incurred in the discharge of the public service obligations, taking into account the relevant revenue and a reasonable profit. Fourthly, and finally, when the company is not chosen through a public procurement procedure, the level of compensation must be determined in relation to an analysis of the costs that a typical company in the sector would incur (taking into account its revenues and a reasonable profit for the discharging of the obligations).

The scholarship has generally welcomed *Altmark*.[517] This decision can be regarded as a desirable *fine-tuning* of *Ferring* on the basis of some of the arguments that emerged in the debate that followed the latter decision.

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[515] Along the same lines see Advocate General Stix-Hackl in Joined Cases C-34/01 to C-38/01 *Enirisorse*.

[516] Cf note 512 above.

[517] Biondi and Rubini (2005); Szyszszak (2004); Biondi (2004); Nicolaides (2003b); Thouvenin and Lorieux (2003). Cf also the 2004 Commission Staff Working Paper - Report on the public consultation on the Green Paper on Services of General Interest. For a recent application of *Altmark* by the Court see Case C-451/03 *Commercialisti*, paragraphs 54 et seq., where, however, the Court was able to find that only the first two

It seems indeed that the Court, in adhering to the compensation approach, has been particularly receptive of the Opinion of Advocate General Jacobs in *GEMO* and its differentiated compensation approach based on the dividing criterion of the direct and manifest link between financing and clearly defined public service obligations. More fundamentally, however, the four conditions of *Altmark* represent a rather successful transplant, after the necessary adjustments, of the main requirements of Article 86(2).[518] That is evident with respect to the entrustment of particular tasks of public service obligation, but is also true with regard to the concepts of necessity and proportionality and the underlying idea that distortions are to be kept to the minimum possible.

The *Altmark* conditions clarify *Ferring* by ensuring i) the adoption of a transparent process ii) to compensate only those costs that are necessary to execute the SGEI. In this regard, apart from the requirement that compensation be linked to an explicit PSO and does not exceed the latter's cost (paragraphs 89 and 92), two new important conditions have been introduced. First, at paragraphs 90 and 91, that the parameters on which the compensation is calculated must be established 'beforehand in an objective and transparent manner'. Significantly, the determination of the compensation *ex ante* should prevent operators from passing all of their commercial risk to the State and avoid *ex post* rescue of inefficient undertakings. Secondly, that in any event compensation is not supposed to cover any cost claimed to be 'extra' or 'additional' but only those costs that satisfy objective, market-based benchmarks and are determined after certain procedures (see paragraph 93). As Nicolaides (2003a) noted, this is an important recognition that the cost of SGEI cannot be determined if the costs of other potential providers are not considered.

It has indeed been argued that the main finding of *Ferring*, whereby mere compensation of the 'additional costs actually incurred' by undertakings entrusted with SGEIs is not State aid, far from restoring the level playing field would end up

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conditions were satisfied, leaving the assessment of the remaining two to the national court.

[518] This tendency is not new. See, for instance, Case C-387/92 *Banco Exterior de España*, paragraph 21 where the Court refers to the possibility that an aid is 'capable of falling outside the scope of application of Article [87] by virtue of Article [86(2)] of the Treaty' (emphasis added). See also Case T-106/95 *FFSA* paragraph 16.

strengthening anti-competitive advantages. Nicolaides, [519] in particular, highlighted that the *Ferring* decision did not clearly require the *necessity* and the *sufficiency* of the compensation.

The proposed solution to these two problems was to auction the obligation to provide the relevant services. [520] By creating a market to obtain the services in question, the public authorities would succeed in not favouring any firm and in keeping the subsidy to the minimum necessary. [521] The idea that an open and fair tendering procedure would exclude the existence of any advantage and hence of a State aid is not new. [522]

The Court has taken account of these arguments. The most significant advancement in *Altmark* is that only the compensation of those costs that are *necessary* to discharge the public service do not constitute State aid. To determine the right amount of financing, the Court clearly indicated its preference for public procurement procedure. Possibly considering the argument that it would be disproportionate to *require* them, [523] it however stopped short of imposing them and put forward an alternative benchmark.

## The interplay between scope and justification: separation or conflation?

One of the main critiques of Advocate General Léger towards *Ferring* was that it did not distinguish between the characterisation of a measure as State aid on the one

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[519] See id (2002a), (2002b), (2003a), (2003b).
[520] Nicolaides (2002a: 195 et seq.)
[521] The *creation of competitive pressure* on public undertakings is not new in the case law. Two examples come immediately to the mind. On the one hand, the Article 86 case-law which put pressures on monopolists that are not manifestly able to provide a service (see, eg, Case C-41/90 *Höfner*) or the case-law which puts the necessity of the breadth of the monopoly itself into question (see, eg, Case C-320/91 *Corbeau*). Another example comes from the internal market, and notably from the 'healthcare services' cases (Cases C-157/99 *Smits and Peerbooms*, C-368/98 *Vanbraekel*, C-385/99 *Müller-Fauré*). For a similar reading of these internal market cases, which underlines the competitive pressure caused by the Court's decisions, see Biondi (2004).
[522] See, for example, Advocate General Jacobs in Case C-126/01 *GEMO*, paragraphs 119 and 129 of the Opinion. Se also the Commission *Non-Paper on Services of General Economic Interest and State Aid* (12 November 2002), paragraphs 84 to 89. For a thorough analysis of the interplay between public procurement procedures and State aid see the very recent work of Bovis (2005).
[523] See Advocate General Stix-Hackl in Joined Cases C-34/01 to C-38/01 *Enirisorse*, paragraph 157; see also the second Opinion of Advocate General Léger in Case C-280/00 *Altmark*, paragraph 97.

hand and its justification on the other. With another expression, the compensation approach would conflate the *separate issues of scope and justification.*

It is argued that this is not the case. Provided that the compensation satisfies the conditions laid down in *Almark*, these cases very much resemble purchases where the compensation is a mere *contropartie* of the PSOs. It is as if the government is *paying* for the public service.

Advocate General Tizzano in *Ferring* already hinted at this logic when he noted that the PSO and the compensation

> cannot be considered as separate matters as they are two sides of the same public measure. [524]

It was Advocate General Jacobs, however, that drew an express parallel between *public service compensation* and a *purchase transaction.* He observed that a comparison should be drawn to the situation where a State buys something and pays the price. It seems indeed immaterial that the service is not provided to the State but to the collectivity. According to Jacobs

> the same global analysis must prevail where the link between State funding and the clearly defined general interest obligations imposed is so direct and manifest that financing and obligation must be regarded as a single measure. [525]

Consequently, there will be aid only if, and only as far as, the *price* paid exceeds the *market price.*

Following the thread of this reasoning, we might consider a compensation, which fulfils the conditions of transparency, proportionality and efficiency of *Altmark*, a *quasi-market transaction.* As such, being comparable to an operation which is consistent with commercial considerations, it should not be regarded as constituting

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[524] See paragraph 61 of the Opinion.

a State aid. It should be noted that to accommodate this conclusion to both possible courses of public conduct, be they economic or non-economic, financing public services, the language of '*quasi*' market transaction has been used.

Most crucially, contrary to Advocate General Léger's argument, there would be no intrusion of public policy objectives in the advantage analysis which would solely rest on an *economic* assessment aimed at getting the service done at the lower, ie most efficient, cost/price.

*Altmark* cannot be said to conflate scope and justification but is rather in line with the often repeated finding whereby under State aid rules the measure at issue is mainly defined on the basis of its *effects* and not its *causes or aims*.

The compensation of public services should thus be distinguished from the other measures that are aimed at compensating *market failures* and *disadvantages*. Whereas the former seems to largely depend on a purely technical assessment, where there is no significant role for the consideration of the *public* nature or aim of the measure, those cases involve socio-economic assessments which should be properly addressed i) under the separate provisions that in the system allows for justifications, and ii) by the Commission that bears legal and political responsibility for its decisions.

Quite similarly, cases involving the compensation of the costs borne by undertakings entrusted with PSOs should be distinguished from those other cases where normal regulations of business introduced to meet various, even social or public, objectives (such as consumer, safety, health or environmental protection) impose extra-costs on undertakings. It seems indeed that, should governments decide to compensate these undertakings for these costs, the financial assistance would undoubtedly constitute a State aid, irrespective of its proportionality with the costs. The distinguishing element seems to lie in the consideration that, whereas these costs are *normally* borne by the undertakings operating in the relevant market, costs for discharging PSOs, which are specifically entrusted by Member States on

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[525] Case C-126/01 *GEMO*, paragraph 122 of the Opinion.

certain undertakings, do not present the same characteristics of normality, but - as seen – present a more marked *quid pro quo* nature.

## 3. The financing of public services under WTO subsidy rules: the GATS

### Public services in an international context: between increasing concerns, diversity and official recognition

It has been already anticipated that the issue of public services has come out prominently in the agenda of the world trading system in the recent years.

Many *concerns* are raised about the possible – negative – impact that further liberalisation, which would allegedly be requested by the WTO rules (and notably the GATS), would have on the access to these services. The ultimate worries are undue interference with *domestically made societal choices* and with *standard lowering*.

Two important remarks are however necessary at this point.

First, the more we leave a rather integrated and culturally quite coherent community such as the EC, the actual *definition* of what would constitute a public service, and even the *perception of its essentiality*, tend to inevitably blur. [526] Whereas in some societies, especially of the developed world, public services are considered as fundamental (in some cases, even inherent in the rights arising from the concept itself of citizenship), [527] in other countries, mainly in the developing part of the world, we do not have any concept or recognition of what, in other jurisdictions, are called public services.

Secondly, this degree of *diversity* inevitably requires the use of basic concepts when defining public services and their contents. From a lawyer's perspective, the progressively diffused perception of the cruciality of these services and of the access thereto, which is evidently linked to the developing human rights discourse, is

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[526] Cf Munari (2004).
[527] See, eg, France.

embodied in many documents from international organizations which increasingly *recognise the importance* of public services and define *minimum standards of protection*. [528]

It is with these remarks in mind that the current debate on the safeguard of public services and the liberalisation of trade can be properly understood. We can now concentrate on the GATS and its *current* impact on public services, focussing, in particular, on the main issue of this section, that is the interplay between subsidy rules and financing of public services.

## The current state of the law (and the prospects for the future)

It should immediately be said that the GATS may apply to public services.

In particular, the interpretation of Article 1.3(b) (“‘services’ includes any service in any sector except services supplied in the exercise of governmental authority’) and (c) (“‘a service supplied in the exercise of governmental authority’ means any service which is supplied neither on a commercial basis nor in competition with one or more service suppliers’) seem to indicate that many services, particularly in those Member States where there has been or there currently is a liberalization process, are covered by the GATS. [529] The construction of the provision above, and in particular of the exception as it result from the combined reading of letter (b) and (c), according to the canons of the Vienna Convention, would lead to conclude that only those services that are not provided for profit (that is *not* ‘on a commercial basis’) and are supplied from (public) monopolist (that is *not* ‘in competition with one or more service suppliers’) would be *excluded* from the scope of application of the GATS.

It is worth repeating a point that has been briefly hinted before. The fact of whether a certain service is subject to the GATS substantially depends on the degree of internal liberalization of the Member State at issue, that is on a *general political choice* of the latter (although, admittedly, this choice may not be completely autonomous but may well be influenced i) by prevailing general *ideological and cultural trends* and,

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[528] See, eg, OECD (2001b), WTO (2001), WTO and WHO (2002); UN HR Commissioner (2002); UNCTAD (2005).
[529] Krajewski (2003a: 347-359); id (2004: 106-107).

most importantly, ii) by *political decisions* made *supranationally* – such as is occurring in the EC – with the result that the ultimate decision of whether to liberalise or not a service would partly fall outside the control of the country at issue).

Krajewski (2004: 107), one of the main experts of the topic, clearly expressed the interplay between domestic and international liberalisation decision when he underlined that '*internal* liberalisation can therefore generate and reinforce *external* liberalisation' (emphasis added).

Before passing on to analyse the impact of the GATS subsidy provision on the financing of public services, it is important to underline the peculiar regulatory approach of the GATS. [530]

The GATS features two different categories of obligations. On the one hand, there are the *general obligations and disciplines* which apply to all Members and to any service subject to the Agreement (including that on Subsidies, Article XV). [531] On the other hand, there are other obligations, and in particular those on Market Access (Article XVI) and National Treatment (Article XVII), which concern *specific commitments* inasmuch as they apply only if, and within the limits which, the Member at issue has *committed* itself in its *schedule*. In absence thereof, that is if there are not specific commitments, the service under scrutiny shall not be subject to those specific obligations.

This way of operation, which shows an inherent flexibility, is often summed with expressions such as 'bottom-up approach' or 'opting in'.

All this makes all the more important the *drafting* of the specific commitments by Members. [532] The 'bottom-up approach' highlights one important fact: that, although the content of the schedule's commitments will result from the *bargaining* *exercise* of the negotiating process (and the inherent pressures to liberalise), the

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[530] For a specific treatise on the the GATS see Krajewski (2003b). A general outline of the Agreement can be found in the mainstream textbooks. See, for instance, Jackson (1997: 306 et seq); Lowenfeld (2003: Chapter 6); Matsushita, Schoenbaum & Mavroidis (2003: Chapter 11); Trebilcock & Howse (2005: Chapter 12).

[531] Reference can, for example, be made to Article II (MFN principle), Article III (Transparency), Article VI (Domestic Regulation), Article VII (Recognition), Article VIII (Monopolies and Exclusive Service Suppliers), Article XIII (Government Procurement), Article XIV (General Exceptions) and, finally, as said, Article XV (Subsidies).

[532] The *US – Gambling* dispute has been a good reminder of this... See Krajewski (2005).

*ultimate responsibility* for *the* commitments towards liberalisation of *that* particular service lies with the Member that has accepted them. [533]

Having determined that the GATS may apply to certain public services, and explained its particular working, the analysis may now focus on the whether as issue similar to that debated in the context of the EC (does the compensation of public services constitute a State aid?) can be envisaged with respect to the GATS provision on subsidies. In this regard, Article XV, which is among the 'general obligations and disciplines', reads:

> Members recognize that, in certain circumstances, subsidies may have distortive effects on trade in services. Members shall enter into negotiations with a view to developing the necessary multilateral disciplines to avoid such trade-distortive effects [footnote on work programme omitted]. The negotiations shall also address the appropriateness of countervailing procedures. Such negotiations shall recognize the role of subsidies in relation to the development programmes of developing countries and take into account the needs of Members, particularly developing country Members, for flexibility in this area. For the purpose of such negotiations, Members shall exchange information concerning all subsidies related to trade in services that they provide to their domestic service suppliers.
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> Any Member which considers that it is adversely affected by a subsidy of another Member may request consultations with that Member on such matters. Such requests shall be accorded sympathetic consideration.

Even a brief reading of this provision shows that the GATS does not feature any substantial discipline on subsidies. In the absence of any discipline, the issue of the *definition* of subsidy would become largely redundant. In this context, to ask whether a 'compensation approach' similar to that adopted by the Court of Justice in *Altmark* with respect to the financing of public services may seem to be a bit speculative, if not pretentious. [534]

In the context of the specific commitments, a provision that already 'bites' with respect to the issue of the financing of public services, is Article XVII.

Suppose that a Member that has specifically committed the public service at issue to commitments, without any express 'condition or limitation', grant a subsidy

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[533] See Krajewski (2004: 113); Munari (2004: 1035).
[534] On national treatment and services see Mattoo (1997).

exclusively to domestic suppliers in order to discharge that public service. Does this amount to a breach of national treatment? If this is so, how should that Member accord a treatment 'no less favourable that that it accords to its own like services and service suppliers'? Admittedly, it could fulfil its national treatment obligation in two ways: either by extending the subsidy to the foreign service supplier(s), or by ceasing to subsidize its domestic supplier(s). This example further demonstrates the importance of schedule commitments drafting.

Two remarks can however be made with respect to posing the issue of the status of public service compensation *in the context of* subsidy rules, one concerning the current situation and one more focussed on future prospects.

First, albeit rather *soft*, some sort of discipline is provided in the second paragraph which refers to the possibility of holding consultations in the event that one Member is adversely affected by a subsidy of another Member. Now, the necessary logical and practical premiss of this exercise is the definition of the concept of subsidy and it is in this regard that, as it has occurred in the EC, the issue of how to consider the compensation of public services obligations may arise.

Further, the text of Article XV might arguably provide some support to the *distinction* we have made above between *advantage analysis* – merely resting on an economic assessment – on the one hand and the *assessment of public policy objectives* on the other, and thus open the way to an argument similar to the EC compensation approach. Reference is made to the separate mention to the *distortive effects on trade* on the one side and to the *development programmes* of developing countries and more in general to the *needs for flexibility* on the other.

Secondly, if not in the spotlight now, the issue may gain relevance in the near future. Article XV refers to *negotiations* about the development of a more substantial regulation of subsidies in the service sectors, which are currently under way.

Admittedly, they do not seem to have produced many results so far. [535] The WTO Trade Report released in July 2006 however reports that 'several delegations have recently suggested that an acceptable approach [to subsidy discipline] might be to use the SCM Agreement definition of subsidies, appropriately modified, as a

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[535] See, eg, W'all and Dunbar (2005: 11-14); Benitah (2005); WTO (2006: 194-195).

working basis upon which to carry forward the negotiations'. [536] Other indications in this direction can be found in Wall and Dunbar (2005: 13).

This reference to the SCM Agreement, which includes a fairly sophisticated definition of subsidies, cannot but be good news. The appropriate *definition of subsidy* is also crucial with respect to the legal status of the financing of public service obligations. Similarly, the issue of the *interplay* (in terms of *separation* or *distinction*) between *scope* and *justification* will result important as well, as it is partly indicated by the general guidelines that Article XV put to the attention of negotiators. [537]

[536] WTO (2006: 195).

[537] Benitah (2005: 21) reports that many WTO Members were of the view that 'there is a need to exempt from general subsidy disciplines those subsidies that are necessary to achieve certain public policy objectives'. Three categories are indicated, namely economic development, environmental, and social development (the former being available only to developing countries).

# Chapter 4

# The beneficiaries

## I. Scope of the Chapter

We have seen in chapter 3 that it is an inherent, and crucial, feature of the definition of both State aids and subsidies that they should confer an advantage.

Whereas in the next chapter we will see how this advantage may negatively alter the conditions of international competition and trade, or positively cope with market imperfections, this chapter ideally follows the previous one by focusing on the beneficiaries of the advantage.

Among the various issues that may arise, we will in particular deal with two of them.

The first issue is the *identification* of its beneficiaries, ie of the persons that should be regarded as benefiting from the financial assistance granted through the subsidy or aid. The subjective impact of the measure may be particularly wide and complex as the same measure may affect the economic and financial position of various persons. What matters for State aid and subsidy rules is to establish that an advantage is granted, directly or indirectly, to an undertaking.

The second issue concentrates on the interpretation of the *specificity or selectivity test* which is present in both systems. Both EC State aid law and WTO subsidy law are only interested in measures that solely benefit 'certain' undertakings or sectors.

## II. The identification of the beneficiaries

### 1. Introduction

This section examines the issue of the *identification* of the beneficiaries, ie the persons that benefit from the advantage granted through the subsidy or State aid.

As in the previous chapter, the *Canada – Aircraft* dispute provides a useful starting point. The Appellate Body noted that:

> a 'benefit' does not exist in the abstract, but must be received and enjoyed by a beneficiary or a recipient. Logically, a "benefit" can be said to arise only if *a person, natural or legal, or a group of persons*, has in fact received something. The term 'benefit', therefore, implies that there must be a recipient. [538]

Thus, it is a 'person, natural or legal, or a group of persons' that will be the 'beneficiary' or 'recipient' of the subsidy of State aid. Now, to produce a distortion the advantage needs to affect the business activity of the undertaking, ie the production of goods or services for consideration.

The identification of the beneficiaries plays an important role at various levels.

First, it plays a crucial role to determine whether the measure falls within the scope of application of State aid or subsidy rules since the beneficiary must be an enterprise or an undertaking. To put it simply, it must be engaged in an economic activity, ie in the provision of goods or services for consideration, and, quite often, in competition with other undertakings. If the measure benefited only employees or consumers, persons that are clearly not involved in any economic activity, there could be no State aid or subsidy.

Secondly, the identification of the beneficiaries of the measure is *one of the main factors* to consider in the analysis of the advantage. The identification of a given undertaking or industry as recipient of financial assistance is certainly of relevance when it comes to determine whether market conditions are satisfied. Similarly, the

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[538] Appellate Body Report, *Canada - Aircraft*, paragraph 154.

process to establish whether a certain measure is a derogation from the general rule certainly depends considerably on the definition of the interested parties.

The proper determination of the beneficiaries is also instrumental to the definition of the *markets* affected by the measure and of the *effects* produced by it.

Finally, the question of who stands to benefit from the intervention has also significant implications from the procedural standpoint, and in particular the application of the *remedies*. State aid or subsidy granted unlawfully could be withdrawn or recovered. In such cases, it is evident that the definition of who is going to be the target of such withdrawal or recovery is important. The issue of the recovery of (past) paid aid is crucial in the EC, but is also relevant in the WTO, at least with respect to the category of prohibited subsidies whose withdrawal should include their retrospective repayment.

Further, in the specific context of the WTO law, countervailing duties may be imposed unilaterally on those products that are held to be subsidised. From this perspective, too, the importance of the identification of who benefits from the subsidy is clear.

As a matter of fact, an advantage may affect the economic position of various individuals. Therefore, it is not possible to concentrate only on the first or more direct recipients of the financial assistance as the advantage may be also (or exclusively) conferred in an indirect way to other persons. A distinction is accordingly usually made between *direct* or *indirect* subsidies.

That said, undertakings can be - more or less directly – benefited in various ways. For example, through the reduction of their production costs (benefits to employees, assistance to research, input subsidies), the increase of their sales revenue (consumer subsidies and benefits to final producers), the provision of capital (aid to investors), the sale of a company or business at particularly favourable contractual conditions, especially as regards price (sale of companies/privatisations).

## 2. Two case-studies

There are also two notable cases where the *buyer* is the indirect beneficiary of the measure of financial assistance and which are worth of further examination.

The first is the case of so called 'upstream' or 'input subsidies'. The second is the case arising out from the sale of companies or businesses that had previously received a subsidy. In both cases, many interesting issues come out from the existence (or not) of a 'pass-through' of the benefit previously granted (as the case may be to input producers or to the company/assets under sale).

### Input subsidies

A particularly interesting case of indirect subsidies is that of so called 'upstream' or 'input' subsidies.

These cases derive from the interdependence of the various levels of production which substantially flows from one of the most popular axioms of economics, ie the division and specialisation of work. In these cases the direct benefit is conferred on the producer of the input (ie upstream in the productive process) and the question is whether this benefit is, totally or partly, passed through downstream to the producer of the final product, for example in the form of a lesser price. As the Panel in *US - Softwood Lumber IV* generally put it, the 'core of the pass-through issue is the notion of subsidization of a product, ie, in respect of is manufacture, production, or export. Where the subsidies at issue are received by someone other than the producer of the investigated product, the question arises whether there is subsidization in respect of that product'. [539]

The issue is, of course, to determine *when* the benefit granted to the input manufacturer passes through to the downstream producer, which is not always straightforward.

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[539] Panel Report, paragraph 7.85.

Although it has often been underlined how particularly complex this determination is, [540] we can start with simple remarks. Most of them have been partly elaborated from considerations that can be found in the seminal work of Beseler & Williams. [541]

It first seems to be quite fair to commence with the finding that the subsidisation of inputs does not *per se* constitute subsidisation of the final product. As we will see, one important principle is that no (irrebuttable) presumption can be introduced in this respect. Admittedly, any particular share of the burden of proof can affect the substantive rights to be proven. Accordingly, the introduction of presumptions (in one direction or another) cannot be of any relevance as they may (even significantly) shift the burden of proof.

Nevertheless, even assuming that a legal system introduced a presumption that the benefit has passed through, it is of crucial importance to allow the rebuttal of this presumption and to do so on reasonable terms (for example, by permitting the proof of significant circumstances). In other words, the share of the burden of proof must be balanced in the sense that it should genuinely lead to the determination of whether the benefit has passed through.

We could tentatively provide some examples of the principles above. Being reasonable to assume that the seller will attempt to maximise its profit, there should be no benefit if the two producers are unrelated and thus really operate at arm's length with each other. Quite similarly, no pass through should be established when the input is eventually sold at a market price and under normal market conditions. [542] (Generally, speaking it might therefore be argued that, in presence of certain circumstances, such as arm's length transactions at normal commercial conditions, it is easier - although by no means conclusive - to presume that no benefit has passed through. This will clearly be explained by the jurisprudence on privatisations of previously subsidized undertakings.)

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[540] Beseler & Williams (1986: 126) who underlined that GATT experts have considered the issue since 1982 (NB: the authors were writing in 1986) without being able to arrive at definitive conclusions. The issue was also subject to extensive debate during the Uruguay Round of negotiations.
[541] Beseler & Williams (1986: 125 to 127).
[542] The authors underline, however, the difficulties of those cases when there is no benchmark, for example because the only domestic sales of the product are those which are subsidised. In these cases, it is noted, it would be important to consider the price of imports.

The case could however be different, with a conclusion that there is passing through, when there is a clear evidence thereof, like when there is a governmental requirement to pass the benefit on.

In any case it is however important to underline that the specificity test, which requires that the benefit must favour only certain undertakings or industries (and which we will thoroughly analyse below), must always be satisfied (and, as has been rightly underlined, this should be done twice: first at the level of the input subsidy and secondly for the pass through of the benefit). (It may be useful to refer to a similar specificity problem which occurs in the importantly debated case of governmental provision of favourably priced natural resources, such as basic energy products: petroleum, petrochemical products, and natural gas. There is a crucial difference, however, between upstream subsidies and natural resource subsidies as, for the latter, by definition we do not have any subsidy issue at the upstream level.)[543]

The case of input subsidies, which was debated during the Uruguay Round negotiations, was the subject of important disputes in the GATT and in the WTO.

## The *US - Pork* dispute

In the GATT *US - Pork* dispute [544] subsidies had been granted to Canadian swine producers. The US had consequently imposed countervailing duties on imported pork processed from swine. The whole question in the case was whether the benefit of the subsidies to swine had translated into, or, in any event, could be considered as, a benefit to its pork, the product processed through swine, for example in the form of reduced swine prices. From another perspective, the whole issue could be summarised in whether we were confronted, as US law provided, with what should have been called as a *direct* subsidy to pork producers, or, on the contrary, whether what was undoubtedly under discussion was direct subsidy to swine producers with a possible *indirect* subsidy to pork producers.

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[543] The issue of whether specificity should be required for upstream and natural resource subsidies has been subject to a certain debate, especially in the US. See, for instance, Barsy (1984); Hubauer & Shelton Erb (1984)

[544] GATT Panel, *US - Pork from Canada*.

Before exposing the main allegation of the US, and the findings of the Panel, it is however advisable to outline briefly the main provisions of US law applicable at the time.

US law had a specific provision for upstream subsidies (Section 771A of the Tariff Act 1930). This provision required a thorough analysis of whether the upstream subsidy had in fact passed through to the downstream producer. What, in particular, had to be established was that the upstream subsidy conferred a 'competitive benefit' on the downstream product and that this had a 'significant effect' on the cost of manufacturing or producing the merchandise. [545]

A new piece of legislation ('Section 771B') was introduced to avoid the strictures of these requirements in some cases. [546] Section 771B provided that, in the case of an agricultural product processed from a raw agricultural product, a subsidy to the latter *should be deemed* to have been granted to the former, provided that two conditions were fulfilled: first, there should have been a substantial dependence of the demand for the input product on that of the output product, and, secondly, only a limited value should have been added in the production of the input into the output. [547] In other words, according to Section 771B, the two separate economic processes were fictitiously merged and the subsidy to the input producer was legally regarded as if *directly* granted to the output producer.

On the basis of this amendment, the US were arguing that in the instant case they were dealing with just one single production process. Being confronted with what in their view was a direct subsidy, it was not necessary to prove the strict requirements (of 'competitive benefit' and 'significant effect') provided for upstream subsidies.

The Panel disagreed. In particular, it first found that, under Article VI:3 GATT, a countervailing duty could be imposed on pork only if it is determined that a subsidy has been bestowed on the production of pork. (It can be recalled that the relevant part of Article VI:3 reads: 'No countervailing duty shall be levied on any product ... in excess of an amount equal to the estimated ... subsidy determined to have been

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[545] For a commentary see Benitah (2001: 269-272).
[546] Section 771B was introduced into the Tariff Act of 1930.
[547] See 19 USC § 1677-2.

granted, directly or indirectly, in the ... production ... of *such product*. [548] ) In the case in issue, however, although it was not disputed that a subsidy had been granted to live *swine*, what was under discussion was precisely whether, in the light of Article VI:3 GATT, this subsidy could be considered as granted to *pork*.

The Panel thus focused on the conditions set by Section 771B to determine whether they were - on their own - sufficient to conclude that, under Article VI:3 GATT, a subsidy granted to swine producers should have been deemed as granted to pork producers. Starting from the obvious consideration that, in the instant case, there were two separate industries operating at arm's length, and two different products, the Panel fully recognised the importance of the price effect in upstream subsidies cases. [549] In particular, it explained that the determination that a downstream industry had been subsidised by an upstream subsidy necessarily required an examination of the *impact of the price* of the subsidies on the input product. [550] Consequently, in the case in issue, the existence of an indirect subsidy could be established if

> subsidies granted to swine producers had led to a decrease in the level of prices for Canadian swine paid by Canadian pork producers below the level they have to pay for swine from other commercially available sources of supply and that this decrease was equivalent to the full amount of the subsidy. [551]

The Panel made it clear that the two factors provided by Section 771B (the substantial dependence of the demand and the limited value added in the production) were not enough to establish that the subsidies to swine had led to a decrease in price in pork. It was underlined that it was necessary to consider various factors to determine whether there was a pass through of the benefit (such as, in the

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[548] Emphasis added.

[549] At the same time, however, the Panel quite intriguingly noted that 'subsidies need not in all cases, particularly in cases involving only one industry, have a price effect to be countervailable' (see paragraph 4.9 of the Panel report). The assumption seems to be that, in such cases, the subsidy effect, which does not affect the price of the product, does have an impact on, say, its quality. In such cases, the artificial advantage granted by the subsidy would nonetheless allow a determination of material injury to be made and countervailing duties to be imposed. (For the various issues on the effects of State aids and subsidy see the next chapter.)

[550] Panel report, paragraph 4.9.

[551] Panel report, paragraph 4.10.

instant case, the degree to which swine were internationally traded, and the per unit cost of producing additional output of swine that the subsidies might have caused).[552]

From the standpoint of US domestic law, the consequence of the Panel's finding of inconsistency with Article VI:3 GATT (and its distinction between direct and indirect subsidies) was that the admittedly more stringent requirements of the US provision on upstream subsidies could not be by-passed. [553] Before imposing countervailing duties on imported pork on the ground that it was subsidised the US should have proved the existence of a 'competitive benefit' on the downstream product and a 'significant effect' on its cost of production

There are two teachings from this case, which can indeed be generalised to other cases where there is a similar question of 'pass-through'. There is first a clear reaffirmation of the important GATT(WTO)-based distinction between *direct* and *indirect* subsidies. Generally speaking, the existence of a subsidy to producer A cannot too much easily, or even automatically, be presumed to have passed through to producer B. This passage has to be established. Further, there is recognition that the working of the passing through mechanism may be particularly complex and, accordingly, a thorough analysis of all the factors of the impact of the input or upstream subsidy on the downstream level of production may be required.

## The *US - Softwood Lumber III* and *IV* disputes

The previous findings have been confirmed in the WTO era, particularly in two recent disputes: *US - Softwood Lumber III* and *US - Softwood Lumber IV*.

The factual background of these cases, which concerned the review of the US preliminary and final countervailing duty determinations on softwood lumber from Canada, is particularly instructive of how complex the production chain of an industry may be. Although the subsidy had originally been conferred on standing timber harvesters, logs were processed, quite often at various stages, to produce

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[552] For a clear explanation of the relevance of these factors see paragraph 4.10 of the Panel report.
[553] Benitah (2001: 210 to 211), however noted that Section 771B still exists in US countervailing duty legislation. It is therefore interesting to know how this provision could now be construed in order to ensure GATT/WTO consistency.

softwood lumber and other products. [554] There could accordingly be many subjects (eg harvesters/loggers; sawmills; re-manufacturers) who subsequently acquired the products as inputs for further processing. If these subjects were independent from each other (ie not vertically integrated), issues of the passing through of the relevant benefit could, at least hypothetically, arise out from various separate arm's length transactions.

Focusing now on the *US - Softwood Lumber III* dispute, the important question which was under scrutiny was whether it is possible to use presumptions in the benefit analysis, or, more specifically, whether, in certain cases, it is possible to *avoid* a pass-through analysis altogether.

The issue was whether the US Department of Commerce (USDOC) was required to examine whether, in certain transactions covered by the investigation, some or all of the alleged benefit to the holders of harvesting rights was passed through to the producers of the subject merchandise exported to the US, in the instant case softwood lumber. [555] What emerged from the record was indeed that in some cases the USDOC had not carried out an analysis of the passing-through of the benefit either i) because it considered that there was no evidence of arm's length transactions between lumber producers and loggers as, in the large majority of cases, they were allegedly not independent from each other, or ii) because, even in cases of arm's length transactions, all undertakings were producers of the same merchandise and the calculation of the countervailing duty was conducted on an aggregate (vs a company-specific) basis. [556]

With respect to the first argument, having found that there was evidence of arm's length transactions, the Panel in *US - Softwood Lumber III* crucially reaffirmed that assumptions or presumptions cannot be used to establish that a benefit has passed through:

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[554] For an exhaustive explanation of the various stages of this industry see Appellate Body, *US - Softwood Lumber IV*, paragraph 124.
[555] Panel report, paragraph 7.69.
[556] Panel report, paragraphs 7.64 to 7.67. The possibility of imposing countervailing duties on an aggregate basis can be found in Article 19.3 SCM.

> we are of the view that an authority may not assume that a subsidy provided to producers of the 'upstream' input product automatically benefits unrelated producers of downstream products, especially if there is evidence on the record of arm's-length transactions between the two. Rather, we consider that in such circumstances the investigating authority should examine whether and to what extent the subsidies bestowed on the upstream producers benefited the downstream producers. [557]

We have already seen that, in principle, it is not possible to *presume* that an upstream subsidy has necessarily transposed into a benefit at the downstream level. The transmission mechanism of the benefit may in fact be so complex that presumptions of this kind do not easily fit in. As said, what seems to be necessary in the case at issue is a more thorough, one would even say empirical, analysis of whether the upstream benefit may have passed through downstream. As hinted by the Panel, this is particularly so when there are some significant factors, such as the existence of an arm's length transaction which, under certain circumstances such as the presence of normal market conditions, may in fact lead towards the opposite conclusion (ie that no pass-through has occurred). In this regard, the Panel interestingly cited the *US - Carbon Steel II* dispute where the Appellate Body concluded in the different context involving subsidies provided to entities subsequently privatized (which we will thoroughly analyse in the next section), that an entity other than the original recipient of the subsidy should not be deemed to have received a benefit when an arm's-length price was paid to acquire the entity that had received the subsidies. [558]

The Appellate Body in the *US - Softwood Lumber IV* case vigorously and extensively reaffirmed the analysis of the Panel, on the need to determine the existence the pass-through of the benefit, when the subsidy has been granted on an input and the countervailing duty is to be imposed on a processed product, and on the connected impossibility of using presumptions when there is an arm's length relationship between upstream and downstream producers. [559] (Returning to the GATT *US - Pork* case, and irrespective of the correctness of the requirements of a 'competitive

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[557] WTO Panel, *US - Softwood Lumber III*, paragraph 7.71. Similar findings were made by the Appellate Body, *US - Softwood Lumber IV*. See, for example, paragraphs 141, 143 and 146.
[558] ibid.
[559] See paragraphs 129 to 147 in particular.

benefit' on the downstream product and the 'significant effect' on its cost of production provided for by the US provision on upstream subsidies, all this seems to be in line with the often repeated need to carry out a comprehensive analysis of the effects of the input subsidy before reaching a conclusion that an advantage has passed on. [560])

As regards the calculation of the subsidy on an aggregate basis (ie on a country-wide as opposed to a company specific basis), the *US - Softwood Lumber III* Panel also confirmed that, in presence of arm's length transactions, it is necessary to carry out a pass-through analysis. [561] In this regard, it is interesting to refer to what the Appellate Body said clarifying the relationship between determination of the existence of subsidisation on the one hand and imposition of countervailing duties on the other. In *US - Softwood Lumber IV* the Appellate Body admitted that Article 19.3 SCM, with the support of Article 19.4, authorises Members to perform an investigation on an *aggregate basis*. [562] However, any definition of the rate of subsidisation for countervailing duty purposes, be it on a country-wide (read: aggregate) basis, or on a company-specific basis can logically take place *only after* the investigating authority has, inter alia, established the existence of a subsidy. Referring to the case in issue, the Appellate Body thus underlined that

> before being entitled to impose countervailing duties on a processed product, for the purpose of offsetting an input subsidy, a Member must first determine, in accordance with Article 1.1 [SCM], that a financial contribution exists, and that the benefit conferred directly on the input producer has been passed through, at least in part, to the producer of the processed product. [563]

The Appellate Body made also it clear that it is in the nature of the imposition of a country-wide (aggregate) rate under Article 19 SCM that the rate of subsidisation

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[560] See Benitah (2001: 269-272) for a very interesting, critical assessment of these requirements and their rationale.

[561] See Panel report, paragraph 7.77 in particular.

[562] With respect to the aggregate-based calculation of countervailing duties, Article 19.3 SCM inter alia provides that 'countervailing duty shall be levied, in the appropriate amounts in each case, on a *non-discriminatory basis* on imports of such product from *all sources* found to be subsidized and causing injury ...' (emphasis added). Article 19.4 SCM reads: 'No countervailing duty shall be levied on any import product in excess of the amount of the subsidy found to exist, calculated in terms of subsidization *per unit* of the subsidized and exported product' (emphasis added).

does not necessarily match the precise amount thereof benefiting a specific shipment or, even, that a particular shipment of the subject merchandise is not subsidised at all. [564] The SCM Agreement itself, however, gives a remedy, providing for specific expedited review of the countervailing duty, if any, to be imposed on the exporter not investigated individually. [565]

## Input 'State aids' in EC law

If we now look at EC law, we can quite simply conclude that considerations as to the pass-through of the benefit in the case of input or upstream State aids similar to those examined above can be made also in the EC. [566]

Even there, in particular in the context of the analysis of the effects of the State aid, it is particularly important to carry out a comprehensive economic analysis which involves the markets involved by the subsidy and a thorough analysis of its effects. As said, the identification of the beneficiaries plays an important role in this respect. [567]

As far as we are aware no cases on input or upstream subsidies have been in the spotlight in the EC. Nevertheless, should it be necessary, we believe that a comprehensive approach, substantially similar to that adopted in the WTO, would be used for determining the impact of input or upstream subsidies. [568] In other words, what can be safely concluded is that in both systems the establishment of a 'pass-through' of the advantage should only be based on a thorough analysis of various economic factors involved and that, in this context, the use of assumption/presumptions should be made with particular care.

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[563] Appellate Body, paragraph 154.
[564] Ibid, paragraph 153.
[565] Article 19.3 SCM provides that '[a]ny exporter whose exports are subject to a definitive countervailing duty but who was not actually investigated ... shall be entitled to an expedited review in order that the investigating authorities promptly establish an individual countervailing duty rate for the exporter.'
[566] Cf, in general, Roberti (1997).
[567] For a comprehensive analysis of the market impact of State aid see Fingleton (2001).
[568] Such a similar analysis is carried out by Roberti (1997).

## Sale of companies or assets

Interesting issues concerning the identification of beneficiaries have come out also in the context of the sale of undertakings which previously received subsidies. This question has mainly come out in the context of privatisations or of reorganisations of companies in difficulties.

Like in the previous case of input subsidies, one of the issues here is whether, following the sale of the company, of its assets or of an entire business, any advantage has passed through to the buyer. As we will see, however, this category raises also other issues on the residence of the advantage which may concern the seller (which, depending on the cases, may be the company or its owners).

## The pass-through of the benefit: the position of the buyer between the use of presumptions and the market

We commence our analysis by considering whether, following the sale of the company or the business, the benefit 'passes through' to the *buyer*.

As we are essentially dealing with a 'pass-through' problem, many issues that have come out in the relevant WTO disputes are very similar to those dealt with in the 'input' subsidy context.

Before proceeding to the analysis of the issues, it may be useful to clarify an important distinction between various sale transactions. On the one side, in *share deal* cases what is sold is the firm or the company (we use the two terms indifferently without referring to any particular legal form of enterprise). The identification of the beneficiary is particularly complex in these cases as they involve the presence of three subjects, the company, the owners/sellers and the owners/buyers. On the other side, we could distinguish between *asset deal* and *business deal* cases. Whereas the former concern the sale of all or part of the assets of a firm, the latter regard the sale of a productive operation as ongoing concern and, as such, they may normally include the transfer of the liabilities of the unit. In these cases the identification of who stands to benefit from the transaction is generally easier as only two subjects (the company/seller and the buyer) are involved. It is therefore natural that in the

subsequent analysis we will particularly concentrate on share deal cases because of their bigger complexity. (It should finally be noted that when we simply use the term sale we generally refer to any sale transaction without distinguishing between share, asset or business deals.)

Having set forth this distinction, we may analyse an interesting issue which focuses on the possibility of using presumptions. We can, hypothetically, think of two kinds of presumptions which admittedly go in opposite directions. First: following the sale, may we presume that the benefit has *simply* passed through? Or, secondly (and to the contrary), should it be presumed that the sale *at certain conditions* (and, notably, an arm's length transaction for a fair market value and in compliance with normal market conditions) *always* extinguishes any benefit? Although we will mainly analyse WTO law, we will attempt to draw a comparison with EC law.

### Presumption of pass-through of the advantage: against automatism

With regard to the first presumption, which is similar to the blunt - and irrebuttable - assumption that an input subsidy *should always pass through* downstream, both the Panel and the Appellate Body rejected this possibility in the *US - Carbon Steel II* dispute. In that case, that concerned leaded bars imported into the US and subject to countervailing duties, the issue was whether the subsidies originally bestowed on an undertaking (BSC) could still be regarded as been granted to its successors (UES and BSplc/BSES). Two specific transactions were under examination: the sale of a productive unit to UES and the privatisation of BSC.

The premiss of the US' argument was that the productive operations of all those companies were essentially the same, and thus there was no need to distinguish between them. This substantially derived from the assumption that, under WTO law, the beneficiary of the subsidy is not a *person* manufacturing a product but rather the *production operations* themselves. [569] On the basis of this argument, the US put forward an irrebuttable presumption that the benefit of a non-recurring (ie provided on an irregular basis) and untied (ie provided on a company basis and not directed at specific products) subsidy continues to flow, even after changes in ownership.

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[569] As seen above, this allegation was based on note 36 to Article 10 SCM and on Article VI:3 GATT.

Both the Panel and the Appellate Body commenced with the premiss that 'logically' a benefit can only refer to a person that has received something (and not simply to its productive operations). [570] They then confirmed that it cannot always and simply be presumed that, in the case of change of ownership of the company or of its assets, the benefit of a subsidy previously granted has passed through to the new owner. [571] In other words, while presumptions that an advantage continues to flow may be used these can never be irrebuttable. Thus, a change in ownership, and in particular the special circumstances surrounding it (such as the compliance with commercial considerations), may require an examination of whether a benefit continues to accrue to the buyer. [572]

The findings of the Panel and the Appellate Body are clearly sound for two reasons.

First, as a matter of general proposition and as is confirmed by various provisions of the GATT and the SCM Agreement, [573] it is always necessary to prove the existence of a benefit for a subsidy to be deemed to exist and to counteract against it. This is particularly so when we are not talking of a direct but rather of an indirect mechanism of transmission of the advantage which occurs when we have a change in ownership.

Secondly, as we have seen analysing the impact of input subsidies above, the determination of any pass-through effect quite often requires a sophisticated analysis. Irrespective of the rules on the share of the burden of proof, which in any event should respect a balance between the parties, this assessment should properly take into account all the factors concerned, and in particular the effects of the financial contribution at issue and of subsequent events, such as a change in

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[570] Panel, *US - Carbon Steel II*, paragraph 6.78; Appellate Body, ibid, paragraph 58. The principle was laid down by the Appellate Body in *Canada - Aircraft*, paragraph 154.
[571] Panel, *US - Carbon Steel II*, paragraph 6.71; see also the Appellate Body in the same dispute, paragraph 62.
[572] See Panel, *US - Carbon Steel II*, paragraph 6.70: Appellate Body Report, ibid, paragraph 62. It is however worth noting that the Appellate Body distinguished the scope of this requirement depending on whether what is in issue is an original investigation (Article 11 SCM) or only an administrative review (Article 21 SCM). See Appellate Body, ibid, paragraph 63.
[573] In the first place by, for example, the definition of benefit in Article 1.1(b) SCM ('a benefit *is* thereby conferred', emphasis added). This is also confirmed by the various provisions on the definition and purpose of countervailing duties which clearly imply that such a measure is only there to counteract an existing subsidy (see, for example, the last sentence of Article VI:3 GATT which is reprised by word in footnote 36 of Article 10 SCM). This reading is also definitely supported by the uncontroversial language of Article 21.1 which says that '[a] countervailing duty shall remain in force ***only as long as and to the extent*** necessary to counteract subsidization which is causing injury', emphasis added. This reasoning is substantially upheld by the Appellate Body, *US - Carbon Steel II*, paragraphs 60 to 62.

ownership and the circumstances surrounding it. The automatist of a presumption that an advantage - quite simply and always - continues to flow or in any event has passed through to the new owner does not seem to sit easily in this context.

It cannot be disputed that a similar conclusion should be reached in EC law as well. As we have shown with respect to input subsidies, there cannot be any irrebuttable presumption that, following a change in ownership, the previously conferred benefit continues to exist. This continuance has to be established and often requires a thorough analysis.

## Presumption of exhaustion of the advantage: the market and the government intervention

The more interesting debate, however, is that concerning the second presumption whereby an arm's length sale for a fair market value and in compliance with normal market conditions should be held to *extinguish* the benefit.

What we see here is an intriguingly evolving reasoning of the WTO jurisprudence.

In the *US - Carbon Steel II* the issue was whether the fact that a 'fair market value' had been paid for the 'productive assets, goodwill, and all other factors' subsequently used by the successor companies in the production of the products imported into the US excluded the existence of a benefit for the new owners.

The focus of the Panel and the Appellate Body was different from the US' one being more concentrated on the *change in ownership* (of the company and/or the production units) and its *conditions*, and in particular on their compliance with a market benchmark, rather than on the *continuance of the productive operations*. Having found that the pass through of the benefit cannot simply be presumed but has to be established, both the Panel and the Appellate Body relied on the often repeated finding that the term benefit implies a comparison with the marketplace. On this basis, they concluded that the payment of a 'fair market value', in the context of an 'arm's length' transaction and in full compliance with 'commercial considerations' (as

has occurred in the instant case with the sale of assets to UES and the privatisation of BSC), excludes that the buyer has 'benefited' from the transaction. [574]

The same principles seem to apply in the EC where the sale of a company at market price is held to extinguish (on the part of the buyer) any advantage accrued from a previous aid. The Court thus held that

> where an undertaking that has benefited from unlawful State aid is bought at the market price, that is to say at the highest price which a private investor acting under normal competitive conditions was ready to pay for that company in the situation it was in, in particular after having enjoyed State aid, the aid element was assessed at the market price and included in the purchase price. In such circumstances, the buyer cannot be regarded as having benefited from an advantage in relation to other economic operators. [575]

In *US - Carbon Steel II* the Appellate Body seemed however to express some caution, restricting its finding on the inexistence of a pass-through of the benefit to 'the facts of the case.' [576]

This caution can be explained if the more recent *US - Countervailing measures* dispute is considered, where one of the motives underlying this qualification could be summarised by the following questions. Is the price of an enterprise which is undergoing a privatisation and which is determined by the market *always* a reliable indicator in a 'pass-through' assessment? Does the fact that one of the main actors in a privatisation process is the *government* somewhat have an impact on this answer?

We have already examined these findings in the previous chapter but, considering their importance, it is worth repeating them.

The Panel found that

> privatizations at arm's length and for fair market value *must* lead to the conclusion that the privatized producer paid for what he got and thus did not

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[574] Panel, *US - Carbon Steel II*, paragraph 6.81; Appellate Body, ibid, paragraph 68.
[575] Case C-277/00 *SMI*, paragraph 80; Case C-390/98, *HJ Banks*, paragraph 77. Cf also Case C-305/89 *Italy v Commission*, paragraphs 39 and 40.
[576] Appellate Body Report, *US - Carbon Steel II*, paragraph 74. This restriction was recognised by the Appellate Body itself in *US - Countervailing Measures*, paragraph 93.

> get any benefit or advantage from the prior financial contribution bestowed upon the state-owned producer. [577]

The Appellate Body highlighted the special role played by governments in the functioning of market economies and, in particular, their ability to direct events and processes, in the instant case privatisations, towards certain, desired directions. The Appellate Body accordingly qualified the finding that privatisations at arm's length and for fair market value *always* exclude that the benefit is passed through. In particular it pointed out that

> the Panel's absolute rule of 'no benefit' may be defensible in the context of transactions between two private parties taking place in reasonably competitive markets; however, it overlooks the ability of governments to obtain certain results from markets by shaping the circumstances and conditions in which markets operate. Privatisations involve complex and long-term investments in which the seller—namely the government—is not necessarily always a passive price taker and, consequently, the 'fair market price' of a state-owned enterprise is not necessarily always unrelated to government action. In privatisations, governments have the ability, by designing economic and other policies, to influence the circumstances and the conditions of the sale so as to obtain a certain market valuation of the enterprise. [578]

This ability to direct privatisations so as to 'influence the circumstances and the conditions of the sale' inevitably affects the reliability of some indicators such as the 'market valuation' (ie the price) of the enterprise. The Appellate Body thus concluded that

> the Panel erred in concluding that '[p]rivatisations at arm's length and for fair market value *must* lead to the conclusion that the privatised producer paid for what he got and thus did not get any benefit or advantage from the prior financial contribution bestowed upon the state-owned producer.' (emphasis added) Privatisation at arm's length and for fair market value *may* result in extinguishing the benefit. Indeed, we find that there is a rebuttable presumption that a benefit ceases to exist after such a privatisation. Nevertheless, it does not *necessarily* do so. There is no inflexible rule *requiring*

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[577] Panel, *US - Countervailing Measures*, paragraph 7.82 (emphasis added).
[578] Appellate Body, *US - Countervailing Measures* paragraph 124.

> that investigating authorities, in future cases, *automatically* determine that a 'benefit' derived from pre-privatisation financial contributions expires following privatisation at arm's length and for fair market value. It depends on the facts of each case. [579]

The main implication of this qualification is, again, an important warning against the possibility of using presumptions, and in particular those that automatically - that is without any possibility of rebuttal - tend to produce a solution to the case. Although it may be assumed that privatisations at arm's length and for fair market value should extinguish the advantage, the Appellate Body clearly shows that this is not always and necessarily the case. It is not a hard and fast rule. Once again (as the case of input subsidies shows), everything depends on a thorough empirical analysis of the facts of the case.

Another implication of the Appellate Body's warning, which we have already examined in the previous chapter, is the difficulty of defining market criteria, especially when the government intervenes in the market. This qualification does not however detract from the fact that, absent any (significant) interference from the government, the price produced by the market is normally a reliable indicator to determine whether any advantage has passed through to the buyer. It is accordingly argued that the importance of commercial criteria should generally be confirmed.

Again, there are no reasons to believe that the economic and legal remarks of the Appellate Body are not of more general application and could not be used in the EC too. The fact that the government is not like any other agent in the market, but could rather play a predominant role therein, should be duly recognised when it is necessary to determine the reliability of market indicators.

An interesting issue of the reliability of prices set by the market has come out in the EC. When the price is determined taking into account the possibility that the buyer might be called to repay the aid, it is likely the latter's value may not be fully incorporated in that price. The intriguing issue is whether, under these

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[579] ibid paragraph 127.

circumstances, such contemplation may imply that part of the benefit should really be considered as passing through to the buyer making him liable. [580]

## The distinctions between the company and its owners and between share, business and asset deals

We have just assessed the position of the buyer, as possible indirect beneficiary of the sale, and the role that market considerations may play in determining whether a benefit passes through or not. We will now seek to widen the discussion by considering the distinctions between share, asset or business deals on the one side and, in the context of share deals, between the firm and its owners on the other. Although we will examine WTO law and EC law separately, we do not renounce to drawing parallels.

### WTO law

The first step of our analysis will move from an intriguing argument strongly put forward by the US in both the *US - Carbon Steel II* and *US - Countervailing Measures* dispute.

According to the US, the benefit resides in the legal person of the firm, or, better, in the production operation, and continues to accrue to it even if its ownership changes, and can be terminated only with the amortization over time of the subsidy (which centres on the average useful life of the subsidised assets) or its reimbursement.

We have seen that, within the context of the determination of whether the benefit had passed through, in *US - Carbon Steel II* the focus of the Panel and the Appellate Body was different from the one put forward by the US and was more concentrated on the *change in ownership* (of the company and/or the production units) and its *conditions* (and in particular on their compliance with the market) rather than on the *continuance of the productive operations*.

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[580] See Advocate General Tizzano in Case C-277/00 *S.MI*, paragraph 79.

In *US - Countervailing Measures*, the Panel, which was asked whether, in the context of the sale of a firm, a distinction should have been made between the 'benefit to the owners of the company' and the 'benefit to the company itself', [581] rejected the distinction between the company and its shareholders as put forward by the US.

On the premiss that 'when someone purchases a company for fair market value, the purchase price includes the value of the benefit conferred to that company', and, taking into account the relationship between a company and its owners (especially following a privatization where the latter seek to maximize their return through the investment in the company), the Panel crucially noted that, for the purposes of the SCM Agreement, there should be no distinction between the advantage conferred to the company or to its owners as, when reference is made to the recipient of the benefit, this should mean both of them together. [582] To support its reasoning, the Panel also quoted the findings of the Panel in *US - Carbon Steel II*, whereby 'it would be misleading in the extreme to suggest that the price paid by the owners of the privatized company is not ultimately paid by the privatized company itself'. [583]

On appeal, the US reiterated their argument. In their view, irrespective of the commercial conditions of the transaction, the benefit always resides with the *legal entity* of the firm. [584] In particular, the conclusion that the privatisation (NB: even following market considerations) should always extinguish the benefit is founded on a 'basic economic misconception' since the privatisation does not move the supply curve to where it has been and thus does not affect the continued existence of the subsidy. [585] In other words, the company that has received the subsidy, being the legal entity that continues to operate on the market, will continue to benefit from it irrespective of its ownership and the relevant market will continue to be distorted by the subsidy.

The Appellate Body confirmed that the benefit should be determined with reference to the market (as we have seen, above, it nonetheless underlined the difficulties of the application of this test). The Appellate Body also explained that a benefit may

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[581] Panel, *US - Countervailing Measures*, paragraph 7.40.
[582] ibid, paragraphs 7.51 to 7.54.
[583] Panel, *US - Carbon Steel*, paragraph 6.82.
[584] Appellate Body, *US - Countervailing measures*, paragraph 88.
[585] Ibid, paragraph 99.

be provided *indirectly* to a firm via its owners. [586] It thus rejected the strict distinction between company and owners as put forward by the US whereby the only relevant consideration for a pass through analysis would be the continued existence of the same legal person and the position of the owners would be completely irrelevant. The Appellate Body, however, also qualified the broad finding of the Panel, whereby a firm and its owners are, for all purposes of the SCM Agreement, virtually the same, underlining that there may well be cases where - from the perspective of the pass through of the benefit - the distinction between the firm and its owners is indeed relevant. [587]

We fully agree with the findings of the Appellate Body on the use of market criteria and on the relevance of changes in ownership to determine the pass through of the advantage.

The crucial point of the analysis should be represented by the previous remarks on market criteria. What is important to do is to distinguish between *utility value* and *market value* of the equipment that the undertaking has acquired with the subsidy. In the determination of whether a benefit continues to exist, it is the latter that should constitute the focal point. [588] We have seen that if the market price is paid the buyer of the company cannot be considered as a beneficiary. Insofar as that price also includes the value of the subsidy it is *as if* the buyer had purchased the shares, which incorporate that value, on the market. From this perspective, therefore, no advantage has passed through.

If we adhere to this premise, the focus of the identification of the beneficiaries should therefore shift from the buyers to either the firm as legal entity or to the actual sellers (the shareholders).

With respect to the allegation that the firm as a legal entity, and in particular its productive operations, would continue to benefit from the subsidy and, by going on to operate on the market, the latter would continue to be distorted, we find this

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[586] Ibid, paragraph 113.

[587] ibid, paragraphs 116-119. In particular, the Appellate Body seemed to hint that in other cases (where, for example, a benefit is conferred through a recurring financial contribution, or where the seller retains a controlling interest in the firm) it may be necessary to distinguish between the company and its owners (ibid, paragraph 117). The finding of the Panel should thus have been limited to the 'very narrow' set of circumstances at issue in that dispute.

[588] See Appellate Body, *US - Countervailing Measures*, paragraph 102.

argument also in the EC. [589] On its face, it seems rather persuasive. The changes in the ownership do not affect the lines of production of the undertaking which continue to benefit from the granted subsidy. As the US put it, the supply curve is not moved back by privatisation and the market will continue to be distorted by the subsidised operations of the firm.

We however believe that, although the *company* should be held to benefit from the transaction if it sells itself the productive operations at market conditions (as we would have a mere exchange of assets for consideration), in the case of privatisation through sale of shares, it is not generally possible to distinguish between the position of the company and that of its new owners. In this regard, we concur with the *US - Carbon Steel II* Panel that 'it would be misleading in the extreme to suggest that the [market] price paid by the owners of the privatized company is not ultimately paid by the privatized company itself' [590] thus, we would add, relieving the latter of any advantage.

The focus of the analysis of the beneficiaries should accordingly shift *from* the *new owners* and the *company* as legal entity *to* those who *sold their shares* being the ultimate beneficiaries of the sale transaction and of the increased value of the company.

We should further ask whether we can really talk about a (persistent) distortion on the part of the company when its shares have been paid the market price (or, in other words, whether we are faced with distortions or misallocations of resources that are relevant for the SCM Agreement). [591] The firm certainly still enjoys the utility value of the (previously subsidised) assets and operations that are currently used in the production but, after the privatisation at arm's length and for fair market consideration, it is really as if it had purchased them on the market.

In the EC context it has been argued that this position may create some difficulties. [592] We could mention the case of a public company floated on the stock exchange. If the shares are sold on the market, and the relevant price is by definition the market price, we could envisage that any sale transaction may involve an aid element

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[589] See, for example, Case C-277/00 *SMI*, paragraph 81; see also in the same case Advocate General Tizzano, paragraphs 82 to 86 of the Opinion.
[590] Paragraph 6.82.
[591] Panel, *US - Countervailing Measures*, paragraph 7.42.
[592] For these arguments see Advocate General Tizzano in Case C-277/00 *SMI*, paragraphs 84 and 85.

for the seller. However, the difficulty of recovering the aid from several hundreds (if not thousands) of seller can be easily imagined. It is also underlined that the shareholders/sellers may not be involved in any economic activity with the result that they could not distort competition in any way.

It has, however, to be underlined that also the other position, whereby the firm as a legal entity, and not its owners, should be liable presents some inconveniences. The Appellate Body has, for example, pointed out to the risk of undermining the SCM Agreement by enabling governments to circumvent it by giving benefits directly to the firm's owners rather than to the firm itself. [593]

In sum, we are inclined to consider that the compliance of the transfer with *market criteria* is liable to exhaust any benefit and hence any distortion (which may be relevant under subsidy or State aid rules) with respect to the *buyer* and the *firm*. Conversely, inasmuch as the market price incorporates the value of the subsidy, the ultimate beneficiary of the *share deal* transaction, and any other possible distortion, should be found among the (former owners/)*sellers* of the firm. Following this reasoning, with respect to *asset deal* transactions following market considerations we tend to believe that it is the firm, as the owner and seller of the assets or the productive operations, that should be considered as the beneficiary.

As regards what we have labelled *business deal* cases, when the sale transaction involve a productive unit as ongoing concern it is interesting to ask whether an argument put forward in the EC context (see below), whereby the transfer would include both assets and liabilities with the result that the buyer might be held liable for the repayment, might be used also in the WTO. In this regard, two remarks are necessary. First, the buyer would be liable not because it is the beneficiary but because it has taken over the liabilities of the business (including that of repayment). Secondly, it seems that, if accepted, this conclusion would be valid only as far as the obligation to withdraw the subsidy is concerned. As regards the exposure to countervailing duties, the crucial consideration is not whether the person is liable for the subsidy but whether it benefits from it. We therefore tend to think that the argument would not touch the buyer as, in case of a market transaction, no benefit

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[593] Appellate Body, *US - Countervailing Measures*, paragraph 115.

passes through. It cannot pass unnoticed, however, that this conclusion would be particularly odd as the persons liable would be different depending on the (multilateral or unilateral) remedy concerned.

## EC law

After having analysed the position as it mainly stands in the WTO, we may now expose the situation that can be found in EC law.

With respect to *asset deal* cases (where, as said, the sale concerns the assets of the firm benefiting from the aid), if the transaction has taken place under commercial conditions, the liability clearly belongs to the seller, ie the company. [594]

By contrast, in the case of *business deals*, where the transfer regards an ongoing concern (with usually encompass both assets and liabilities), it has been maintained that the buyer might be held liable. [595] As already said with respect to WTO law, it is worth repeating that, in such cases, the buyer would be liable not because it is the beneficiary of the aid but because it is the party that has taken over the liabilities of the business. [596]

As regards *share deal* cases, we have seen that the buyer's liability is excluded when the share price reflects the market price. [597] With respect to the identification of the actual beneficiary Advocate General Tizzano in the recent *SMI* case observed that the Court seems to oscillate between two positions, requiring the repayment of the aid either by the company itself or by the sellers of the shares, ie the owners (when the share price reflects the value of the aid granted) [598]

The former position, which echoes that advanced by the US government in the *Carbon Steel II* and *US - Countervailing Measures* disputes, is well represented by the following very recent findings (April 2004) in the *SMI* decision:

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[594] Ibid, paragraph 98.
[595] See Advocate General Geelhoed in Joined Cases C-328/99 and C-399/00 *Italy and SIM* v *Commission*, paragraph 82 of the Opinion.
[596] This distinction was correctly made by Advocate General Van Gerven in Case C-305/89 *Alfa Romeo*, at paragraph 23 of the Opinion.
[597] See note 575 above.
[598] Case C-277/00, paragraphs 82 of the Opinion.

> the undertaking to which unlawful State aid was granted retains its legal personality and continues to carry out, for its own account, the activities subsidised by the State aid. Therefore, it is normally this undertaking that retains the competitive advantage connected with that aid and it is therefore this undertaking that must be required to repay an amount equal to that aid. [599]

This liability of the company should be distinguished from the doctrine of the *single economic unit* that can also be found in the EC. According to this theory, companies belonging to the same group (for example, controlled by the same holding) would be regarded, from an economic and legal point of view, as a single 'undertaking' for the purposes of State aid rules with the consequence that the obligation to repay the aid would concern all of them. [600] (It may however be argued that the application of this principle is often more dependent on needs of simplicity of proof and effectiveness of the recovery rather than on its soundness with respect to the actual determination that the benefit has passed through.)

As regards the latter position of the Court, whereby the repayment of the aid is required by the sellers of the shares, we can refer to the *Banks* decision where it was made it clear that

> where a company which has benefited from aid has been sold at the market price, the purchase price reflects the consequences of the previous aid, and it is the seller of that company that keeps the benefit of the aid. In that case, the previous situation is to be restored primarily through repayment of the aid by the seller. [601]

We have already explained in the WTO context our preference for this reading whereby it is not the company but the shareholders/sellers that should be held liable. We believe that the same arguments would support the same conclusion in EC law.

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[599] Ibid, paragraph 81 of the decision. The Court followed the persuasive reasoning of Advocate General Tizzano in paragraphs 83 to 85 of the Opinion. See also Case C-303/88, *ENI Lanerossi*, paragraph 57.
[600] See Case 323/82 *Intermills*, paragraph 12; see also Advocate General Geelhoed in Joined Cases C-328/99 and C-399/00 *Italy and SIM* v *Commission*, paragraph 79 of the Opinion.
[601] Case C-290/98 *Banks*, paragraph 78. See also Joined Cases C-74/00P and C-75/00P *Falck*, paragraph 180. Case C-350/93 *ENI Lanerossi II*, paragraph 22. This is also the conclusion arguably reached by the Court in

## The case of circumvention of the repayment

We will now reconsider the position of the beneficiary, and in particular of the buyer, in those cases where it is alleged that the sale transaction is designed to circumvent the (obligation of) repayment of the subsidy.

We have said that, when the sale transaction takes place under normal market conditions, the buyer is generally safe since he is not considered as benefiting from the aid and thus cannot be required to repay anything.

There are however cases where it has been advanced that the buyer is not relieved from the obligation to repay the subsidy. This issue has come out especially in the EC, where, particularly in the case of the reorganisation of groups in difficulties or even on occasion of bankruptcy procedures, all the assets - including the benefit deriving from the subsidy - were transferred to a new company, thus leaving the liabilities - including the duty to repay the subsidy - to the original beneficiaries. Quite often, in these cases, the allegation is that there seems to be an attempt to circumvent the duty to repay an unlawful or incompatible aid.

### EC law

We may commence our analysis with few general remarks on the importance of the obligation of repayment in the EC system which will prove important when we draw a parallel with WTO law.

In the EC the obligation to repay any aid that is unlawful or is considered by the Commission as incompatible with the common market is one of the cornerstones of the system of State aid control inasmuch as it guarantees its effectiveness. [602] EC law has thus been construed to provide both these obligations of repayment. With special regard to the recovery of so-called 'unlawful' aid (ie aid unlawfully granted before the Commission has authorised it) this depends on two obligations provided for under Article 88(3), that is the notification obligation (whereby any plans to

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the recent Joined Cases C-328/99 and C-399/00 *Seleco*, paragraph 85, although the reasoning is rather ambiguous fluctuating between an obligation of the company and of the owners/sellers.

[602] As regards the recovery of unlawful aid and the effectiveness of the standstill obligation see Case C-354/90 *Salmon*, paragraph 16; Case C-39/93 *SFEI*, paragraphs 45 and 69. See also Case 70/72 *Commission* v

grant aid should be notified to the Commission) and the standstill obligation (whereby the relevant measures shall not be put into effect until the procedure before the Commission has resulted in a final - positive - decision), and is reinforced by the direct effect before national courts of the last sentence of that provision. [603] That prohibition gives rise to subjective rights in favour of individuals that national courts are bound to safeguard. In particular, national courts must offer the certain prospect that all the necessary inferences will be drawn, in accordance with their national law, as regards the validity of measures giving effect to the aid, the recovery of financial support granted in disregard of that provision, and possible interim measures. [604]

The need to remove in any way the distortion on competition caused by the aid is consistently repeated by saying that the repayment seeks to re-establish the previously existing situation. [605] It may be useful to underline that this is only apparently constrained by the principle of procedural autonomy of the Member State in the recovery of the aid inasmuch as such autonomy should always guarantee that the remedies at issue (apart from being equivalent to those used to protect national rights) are effective to safeguard Community law. [606]

Against the particular background of the EC system, where we have the preventive centralised control of the Commission and where the repayment of unlawful or incompatible aid is the rule, we can appreciate the fears that through artificial company reorganisations the obligation of repayment could be circumvented. From this perspective, the question becomes whether legal formality should prevail - thus impeding the recovery of the aid from the transferee - or whether the economic

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*Germany*, paragraph 20 where the Court sanctioned the power of the Commission to order the recovery of incompatible aid. This power is clearly of crucial importance for the functioning of the system.

[603] The Court has made it clear that the 'recovery of unlawful aid is the logical consequence that it is unlawful' (see Case C-142/87 *Tubemeuse*, paragraph 66. It has also been quite early recognised that the standstill obligation in that provision is directly effective. See Case 6/64 *Costa* v *ENEL*, page 596; Case 120/73 *Lorenz*, paragraph 8.

[604] Case C-354/90 *Salmon*, paragraph 12.

[605] See, for example, Case C-382/99 *Netherlands* v *Commission*, paragraph 89; more recently, see Joined Cases C-238/99 and C-399/00 *Italy and SIM* v *Commission*, paragraph 65. Cf also Case C-350/93 *Commission* v *Italy*, paragraph 22, and Case C-277/00 *Germany* v *Commission*, where the Court held at paragraph 76 that 'the main purpose of the repayment of unlawfully paid State aid is to eliminate the distortion of competition caused by the competitive advantage afforded by the unlawful aid'.

[606] See Case 120/73 *Lorenz*, paragraph 9; see also Advocate General Jacobs in Case C-126/01 *Gemo*, paragraph 44.

substance of the situation should be looked at - thus allowing the recovery from the transferee.

We are however of the view that if the buyer has to be held responsible this has to occur only in limited and well defined circumstances. This is particularly so if the buyer has paid the market price so that he should in principle be held to be safe from any liability. [607] Moreover, from the perspective of the creditors (including the Member State seeking the recovery of the aid) of the undertaking in bankruptcy [608] the sale of shares or assets at the market price is not liable to prejudice their position inasmuch as it does not remove resources from the bankrupt undertaking's assets. [609]

We have said that it is sometimes alleged that the buyer should be held liable in cases of fraud or circumvention of the law. [610] It has however to be noted these concepts are inherently elusive and difficult to define, in particular as far as the proof of their subjective element - the intention to circumvent the law - is concerned. It could be advanced that the presence of certain objective elements concomitant with the transfer transaction, such as the opening by the Commission of a procedure of control under Article 88 EC, might show the presence of a fraudulent intention. However, certain elements, such as the fact that the transaction has taken place at market conditions or that, in the context of insolvency proceedings, the transaction was carried out by administrators or under judicial supervision, [611] may in fact lead to the conclusion that no circumvention has been perpetrated. In short, the reality is that the burden of proof concerning the *intention*

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[607] Cf Case C-277/00 *SMI*, paragraphs 80, 86 and 92. It should be noted that it has been argued that the 'market' price would not be an appropriate indicator as it would be particularly low because of the situation of difficulty of the seller and would thus allow part of the advantage of the subsidy to pass through to the buyer. This is particularly clear in the case of bankruptcy proceedings. See Advocate General Geelhoed in Joined Cases C-328/99 and C-399/00 *Italy and SIM* v *Commission*, paragraph 82 of the Opinion.

[608] It may be recalled that it is commonly accepted that the re-establishment of the previous situation and the elimination of the distortion of competition resulting from the unlawfully paid aid may, in principle, be achieved by registration of the liability relating to the repayment of the aid in question in the schedule of liabilities, and that such registration would be sufficient. See Case C-277/00 *SMI*, paragraph 85. See also Case 52/84 *Commission* v *Belgium*, paragraph 14; Case C-142/87 *Tubemeuse*, paragraphs 60 to 62.

[609] Case C-277/00, *SMI*, paragraph 92.

[610] Levi (2005) page 221; Rehbinder (2004) page 129; for the argument whereby repayment might be ordered to the buyer even if there is no fraud see Levi, ibid, pages 221 and 222, who relies on recital 10 of Reg 794/2004.

[611] See Case C-277/00 *SMI*, paragraphs 92 and 93.

to circumvent the duty to repay is not easy to discharge, as it is shown by the case law on the abuse of right doctrine. [612]

This difficulty does not detract from the fact that (even) Member States may indeed be found to have devised mechanisms to circumvent the obligation to recover. The Court has thus very recently found that legislation permitting the transfer, without any consideration, of the personnel and the most profitable assets of an airline, free of all the company's debts, to a new company, and making it impossible to recover the former company's debts from the new firm constituted an obstacle to the repayment of the aid and to the effective implementation of the Commission's order of recovery. [613]

**WTO law**

It could now be asked whether this issue that has come out in the context of the EC could also be relevant in the WTO. This question will provide us with the opportunity to focus on the general features of the WTO system of subsidy control.

It should immediately be recalled that, in the context of WTO law, the importance of the identification of the beneficiary of the subsidy has a double relevance at the remedial level inasmuch as it could be the basis of a withdrawal of the subsidy or of the imposition of a countervailing duty. Clearly, the issue of the circumvention could arise in either context. For the sake of the comparison with EC law, in our analysis we will however concentrate only on the possible withdrawal of the subsidy.

It is indeed known that, according to the *Australia - Leather 21.5* Panel, the withdrawal of subsidies should include their retrospective repayment, at least with respect to the category of prohibited subsidies (the state of the law with respect to actionable subsidies is still uncertain). [614] Despite the lack of success of this doctrine in the following disputes, [615] it could however be argued that also in the

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[612] This is another case where a difficult concept is rarely applied. Despite affirming the abuse of right doctrine in principle, the Court has thus always been quite reluctant to follow this line of argument. We can for example refer to the interesting case law on the establishment of secondary seats of companies.

[613] See Case C-415/03 *Commission* v *Greece*, paragraphs 32 to 34. For other more recent cases where the claim has been rejected by the Court see Case T-324/00 *CDAI; Case T-138/00 Freistaat Thüringen.*

[614] See Panel, *Australia - Automotive Leather Article 21.5*, paragraph 6.22.

[615] The *Australia - Automotive Leather* implementation Panel report was the first ruling to recommend a retroactive remedy in WTO law. Although its impact for the development of WTO law might be

WTO legal system the fraudulence of company reorganisations to elude the effectiveness of the remedy could be relevant in these cases and the buyer could be held liable of the repayment of the subsidy. Even more so, when it is established that a benefit has in fact passed through in favour of the buyer because, for example, market conditions have not been followed.

At the same time, however, the different emphasis in the two systems with respect to the retroactivity of the remedies seems to provide an opposite argument.

It is indeed known that remedies in the WTO are generally prospective (ie are effective only as far as future conduct is concerned) and only rarely (and, quite interestingly, in some GATT countervailing and anti-dumping duties cases) a retroactive effect has been recognised. [616] Clearly, however, this temporal limitation would have a significant impact on the possibility of drawing a comparison with EC law where the retroactivity of the repayment is the rule. It has however rightly been noted that 'purely prospective remedies hardly constitute a deterrent effect against potential violators', [617] as is indeed witnessed by the experience in the EC and by the case law of the Court of Justice stressing the importance of the repayment of unlawful and incompatible aid.

Finally, the weakness of the remedies is accompanied by the known relative flexibility in the compliance of DSB's decisions. Although full compliance with the rulings and recommendations of the DSB, which usually requires the withdrawal of the measures found to be inconsistent with WTO law (see Article 3.7 DSU) is the first objective of the dispute settlement system, the regime provides for other paths, in the form of compensation or suspension of concessions, that, at least in theory, should only be temporary solutions (ibid). A similar flexibility cannot be found in the EC system where compliance with the decisions of the Court of Justice can even be enforced with penalties (see Article 228(2) EC).

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considerable, it seems that Panels and the Appellate Body in subsequent disputes have carefully avoided applying that drastic remedy. Cf, for example, Panel, *Canada - Aircraft Article 21.5*, paragraphs 5.47 and 5.48; Appellate Body, *US - FSC*, paragraph 178.

[616] For a comprehensive account on remedies in WTO law see Mavroidis (2000).

[617] Ibid, page 790.

The weakness of the remedies (as compared with the EC) is coupled with another general factor that may weaken the scope of the obligation to recover unlawful subsidies, that is the laxity of the system of control of subsidies.

The procedural and institutional frameworks of EC and WTO law are obviously different with the latter still lagging behind the complexity of the former. In particular, WTO law does not provide yet for a preventive system of authorisation carried out by a supranational body in all cases of planned aid. Notification obligations are of more limited scope, usually concerning aid already granted or maintained (Article 25.2 SCM), the only notable exception being that of non-actionable subsidies (Article 8.3 SCM). [618] Moreover, we do not have a true and comprehensive authorisation system, the more stringent control being provided for non-actionable subsidies in the two forms of review under Articles 8 and 9 SCM. In short, it seems that the procedural and institutional system of control of subsidies is less rigorous than that in the EC.

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[618] Non-actionable subsidies have to be notified in advance of their implementation to the Committee on Subsidies and Countervailing Measures. In default of notification the subsidy may be considered as actionable or subject to countervailing duty investigations until its non-actionable status is ascertained (see note 35 of the SCM).

## III. The idea and analysis of specificity

### 1. Introduction

Both EC law and WTO law require that a State aid and a subsidy be specific inasmuch as it should confer an advantage only on certain economic subjects. Article 87 EC provides that State aid should distort competition by favouring *certain* undertakings or the production of *certain* goods. As chapeau to a more elaborate provision, Article 2 SCM defines the concept by referring to a subsidy specific to *certain* enterprises, ie to an enterprise or industry or group of enterprises or industries.

Two remarks can immediately be made.

First, the immediate impression is that this requirement is clearly intended to operate as a tool to *limit* the measures that are regulated by State aid or subsidy rules. Secondly, its underlying *rationale* is not fully clear. Better, it is not clear whether there is *any* or indeed *more than one.*

We will commence our analysis by attempting to answer these questions: does the specificity idea have a rationale underlying it? If so, what is/are it/they? The identification of the justification(s) of the concept of specificity is crucial to approach confidently the second part of the analysis, which focuses on some of its most interesting applications. Only by following this process, we will be in the position to assess whether the operation of the specificity test is in line with its alleged justifications and, eventually, whether our first impression that it is a *sieve* is in fact validated.

### 2. The justification of the idea of specificity

The idea of specificity has generally found two broad types of rationales, economic and non-economic. [619] We will analyse them in turn.

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[619] There is a wide literature on the issue, particularly American, since it is there that the test flourished. See, eg, Barceló (1977); Bello and Holmer (1984/1985); Cameron and Berg (1985); Sussman (1986); Panzarella (1986); Alexander (1989); Ragosta and Shanker (1994).

## Economic rationales

The common proposition that economists make to justify the use of a specificity test is that specific measures would be, or at least would have the potential of being, more distortive than general ones. [620]

This is sometimes linked to the idea of comparative advantage. [621] It is in particular said that specific subsidies would particularly interfere with the allocation of resources domestically - and hence internationally - thus shifting artificially comparative advantages between countries. [622]

In particular, subsidies may alter the comparative advantage for two reasons: first because they are liable to reduce the costs of the recipient, secondly because they attract resources towards the recipient market.

Presumably, the impact on competition and competitors would be particularly noticeable when competitive advantages are not well defined (which occurs when the economies of the two countries and of the two industries are close) and when there is consequently a lot of intra-industry trade in the good or service at issue.

Along these lines, with a dangerous reasoning *a contrario*, Benitah (2001: 258) critically conclude that

> [t]his type of "distortion" would not have taken place had the subsidy been generally available to all industries. In such a case, these industries would have been on equal terms for obtaining scarce productive resources and the mechanism described above could not have taken place.

That said, the fact that more specific interventions would be *more* distortive than generic ones is often criticised.

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[620] See, eg, Friederiszick, Röller and Verouden (2006: 5 and 45); OFT (2005: 35); OFT (2004: 22 and 29); Frontier Economics (2004: 15 and 16).

[621] For a general introduction on the theory of comparative advantage cf Trebilcock & Howse (1999); for a more detailed analysis see Krugman & Obstfeld (1999).

[622] This is, for example, the argument put forward by Harper and Schwartz (1972: 840) which seems to imply that subsidies be specific. For a reformulation of this argument (from a critical perspective) see Benitah (2001: 258).

In this regard, the writer cannot resist citing an anecdote. It is reported that, at a Committee's meeting of the 25th October 1990 during the Uruguay Round Negotiations, the representative of the United States – the cradle of the specificity test – observed that

> it had no economic justification. ... Obviously, the specificity concept was still embedded in US law and regulations. However, the United States had concluded that the concept, which it had created and promoted, did not have the degree of attractiveness once attributed to it. The United States had the intellectual honesty to so admit, and it would seek to convince others in the proper negotiating forum of that change of view. [623]

Leaving the diplomatic arena to turn to economics again, it is commonly conceded that general measures of interventions are less likely to involve rent-seeking (ie the hunt to get the government to intervene so as to make one's business more profitable). [624] There is on the contrary some disagreement on whether they are more likely to be targeted at - and hence effective at solving - failures (ie imperfections) of the market. [625]

That said, it is however increasingly argued that general measures too may alter the comparative advantage of countries (which are for example increasingly linked to social investments in health, education, law and order, basic research, and physical infrastructure) thus distorting competition and trade. [626]

According to OECD (2001: 29- 30), this may in particular occur when the relevant product or service markets are broader than the national boundaries. Even if the measure at issue apply to all firms within the country (and hence is considered as general) it will still be capable to affect the position of those foreign firms that compete with (read: that operate in the same relevant product or service market of) national firms of the benefited industries.

A notable recognition that general measures too might distort competition can be traced back to the very roots of the European Community, the Spaak Report, which

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[623] GATT Doc No SCM/M/48, 15-16.
[624] Trebilcock & Howse (2005: 289); OFT (2005: 35); Besley and Seabright (1999: 20).
[625] For the positive Besley and Seabright (1999: 20); for the negative see, eg, OFT (2005: 35-36).

laid down the basis for Articles 96 and 97 EC (on the approximation of laws to tackle distortions of competition).

One traditional argument in defence of general measures is that they would generally be neutral as any distorting effect would be compensated by other macro-economic factors. It is thus observed that, in the context of a floating exchange-rate world, the effects of general measures would be quite minimal because they would be adjusted by exchange rate mechanisms. [627] Trebilcock and Howse (2005: 289) have however recently noted that in an international environment where exchange rates are increasingly determined by international capital flows rather than good flows the said adjustment becomes more difficult. It should further be noted that, at least in the context of the EC, this argument can by no means be predicated with respect to those countries that share a common monetary policy whose central element is the adoption of a single currency, the Euro.

Also the argument that the distortive effect of general interventions would be decreased, or even eliminated, because any advantage arising from them would normally be financed, at least partly, by the same beneficiaries of the measures is not far-reaching as there is not necessarily any such symmetry between the financing of the measure and its anti-competitive impact.

Assuming that also general measures may be distortive, the paradoxical nature of the specificity criterion is often highlighted.

Lowenfeld (2002: 237- 238) pragmatically observed that, from the perspective of the competitors, it is indeed irrelevant whether they are the only ones to be injured or whether other sectors of the economy are distorted as well.

Along this path, on the assumption 'the wider the more distortive', it is even argued that it cannot possibly be understood why individual or sectoral subsidies would be caught by the regulation whereas measures of wider scope would be permitted.

This is the suggestive argument put forward in the EC by Advocate General Capotorti in *Buy Irish* where he noted that

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[626] See Trebilcock and Howse (1999: 289).

> quite apart from the wording of Article [87 EC], it is perfectly justifiable to speak of a general principle of the prohibition of public aids to domestic products. [628]

What the previous exposition shows is that the economics underlying the concept of specificity is not unambiguous. Although the impact of specific subsidies is quite probably more apparent than those of general measures, the specificity test can at most be grounded on what has been termed by Benitah (2001: 256 et seq) a simple idea of distortion.

The insufficiency of economics to fully justify the idea of specificity cannot however lead to conclude that the latter 'stands as a surrogate for an efficiency analysis'. [629]

This is not correct for two reasons.

First, as chapter 5 will show, an analysis largely based on efficiency considerations is (or should be) carried out in both the EC and WTO at a subsequent stage, when the negative and positive effects of the measure at issue are assessed and balanced with each other. In this light, as has been argued with respect to the use of market criteria in the advantage analysis, the fact that the specificity test would be based on a 'simple' idea of distortion is not per se a minus. Neither the advantage nor the specificity have the duty to tell us whether there is a distortion or a correction of a distortion.

Further, although conceding that the economics underlying the concept of specificity is not fully clear, some agreement can be gathered around the idea that the specificity criterion may reasonably capture those measures that are *more easily liable* to distort efficient market outcomes.

In the absence of a clear theoretical rationale for judging the welfare implications of a greater or lesser degree of specificity in a subsidy intervention, Low (2001: 114 and 120) has accordingly acknowledged that specificity should be considered as a 'valid rule of thumb' for focusing on those subsidies that are likely to be more distorting.

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[627] Jackson (1997: 297); Beseler & Williams (1986: 138). For the EC, see also the *Spaak Report* (1956).
[628] Case 249/81, page 4031.
[629] Tarullo (1986/1987: 560). Cf, along this same line of argument, Ahlborn and Berg (2004: 54-55)'s allegation that, under EC law, that there is not necessarily any direct link between the distortion underlying the specificity criterion and the effects of the subsidy.

[630] For example, certain forms of intervention that are especially likely to distort competition, such as support to failing firms, are usually discriminatory inasmuch as they are given only to firms known to be failing. [631]

In short, we can conclude this paragraph by underlying that, although it would be too radical to conclude that the specificity requirement does not have any economic justification (as the US attempted to do at the end of the Uruguay Round Negotiations), economics *alone* does not explain its rationale. As Professor Jackson (1997: 297) lapidarily put it

> economic arguments can only go part of the way toward explaining [its rationale].

## Non-economic rationales

Having concluded for the insufficiency of economics to exhaustively justify the requirement of specificity, in this paragraph we will enquire whether the analysis of non-economic considerations can contribute to define its justification. In particular, we will focus on arguments of political and practical nature.

It is indeed often argued that the true rationale of specificity should be found in political or practical reasons. [632]

On the one hand, there are reasons of *pragmatic* order. Beviglia Zampetti (1996: 21) thus argues that the requirement that only measures concerning certain undertakings should be subject to the scrutiny of State aid and subsidy rules would avoid a 'painstaking' review of too many governmental measures that may distort competition and trade. (This argument bears a significant resemblance with one put forward by Advocate General Jacobs in the context of the debate on the necessity of a transfer of State resources.) [633] With another nice formulation Hufbauer and Shelton-Erb (1984: 92) noted that:

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[630] Low (2001: 114 and 120).
[631] OECD (2001: 19).
[632] See, eg, Bello and Holmer (1984/1985: 308); Jackson (1997: 297); Barceló (1977: 836-837); Beviglia Zampetti (1996: 21);
[633] See, Case C-52/97 *Viscido*, paragraph 18 of the Opinion.

> [t]he special favor concept now appears to serve as Ockham's razor to eliminate a wide range of government programs from the sphere on international law.

From this perspective, the specificity rationale would eventually lie in a *lex parsimoniae*, in a law of succinctness. In modern words, of administrative/judicial economy.

It is also observed that subjecting general measures to the scrutiny of subsidy rules could lead to the imposition of countervailing duties on virtually every product entering international trade and could thus jeopardise the functioning of the international trading order itself. [634]

On the other hand, the selection operated by the specificity requirement would find a justification in considerations of more *political* order. General measures would require more deference and self-restraint. We have seen that, contrary to more specific measures, they are quite probably less distortive of competition and trade and are more easily justifiable in terms of legitimate public objectives. This could in turn more simply reflect the exercise of sovereign prerogatives. This argument is often formulated in terms of an 'everybody-does-so' rationale which would justify the need to eliminate from the scrutiny of State aid and subsidy rules certain measures. This argument is well explained by a passage of Jackson (1997: 297):

> [i]f we recognize the need to eliminate from the subset of subsidies called 'actionable' the general activities that all governments undertake (such as societal infrastructure like police, fire protection, roads, schools, etc), the specificity test can offer a very useful method for doing so. Thus, it can be argued that part of the rationale for the specificity test is that it is useful as a tool of administration (albeit sometimes blunt) to get rid of a number of cases which really ought not be brought into a countervailing duty or other international rule process.

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[634] Jackson (1997: 293). See also Barcelo (1977: 836) and Hufbauer & Shelton-Erb (1984: 92).

Interestingly, it is recognised that the specificity test can be *blunt*. This echoes our previous finding that, from an economic standpoint, specificity may be viewed as a reasonable approximation, a *rule of thumb*.

As are about to explain, this lack of precision can be reconciled with the *political economy* rationale of the specificity test.

## A truly political economy justification

We have seen that economics can only partly justify the specificity test, inasmuch as it constitutes, at most, a 'valid rule of thumb' to identify the most blatant distortions. We have also seen that this economic idea of simple or potential distortion should be coupled by important considerations of political and practical conveniency.

Combining both lines of argumentation, it could thus be concluded that the requirement of specificity finds its grounding in the realm of *political economy*, ie in the place where the findings of economic theory (which are based on efficiency considerations) serve (only) as a basis for political choices. In other words, this term significantly draws attention to *political motivation* giving shape to economic policies and choices. [635]

There is a clear consequence deriving from this political economic rationale which can be summed up in a question: is specificity sufficiently *specific?*

This question particularly refers i) to the *flexibility/uncertainty*, and ii) to the *expansiveness* that can both characterize the specificity analysis once it steps into the realm of political economy.

On the one hand, as a direct consequence of the discretional nature of the requirement, which depends on its political/pragmatic rationale, it can be noted that specificity is a *flexible* tool. As an inevitable corollary, the prediction of the results of the assessment is often *uncertain*.

On the other hand, as we will see below, the application of this requirement seems to show a trend towards *expansiveness*.

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[635] Cf Black's Dictionary of Economics (2003: 358).

In this regard, a contradiction should be underlined.

The *chapeau* of Article 2.1 SCM explains that the phrase 'certain enterprises' should refer to *'an* enterprise or industry or group of enterprises or industries' (emphasis added). On its part, we have seen that Article 87(1) EC regulates those measures that favour 'certain undertakings or the production of certain goods'. It has accordingly been observed that the language used by the two legal systems clearly indicates a limited scope of application (see, again, the article in the singular in Article 2.1 SCM).

In other words, it seems that 'certain' should be construed as 'few' (if not, in the SCM, 'one' only). This conclusion seems to be confirmed if the traditional theory of comparative advantage is endorsed, which refers to the competitive position of well-defined industries.

However, in many cases, the application of the test in the two systems seems often to indicate a *wide reach* which can in turn put into question the *selectiveness* of the specificity requirement.

## 3. The application of the specificity test

### The specificity analysis and its test

Whereas the GATT 1947 did not make any mention to any specificity analysis, the Treaty of Rome adopted a few years later already incorporated the short legal formulation of the specificity criterion of Article 87(1) EC (whereby the measure at issue should favour certain undertakings or the production of certain sectors) that has never been amended and has been developed in the practice of the Commission and in the case law of the Court.

Over the years GATT/WTO faced an interesting evolution. Although not providing an express specificity requirement, various provisions of the Tokyo Subsidy Code (see, eg, Article 11.3) were already hinting at this test which was commonly used in the application of CV duties in many jurisdictions, including the

US and the EC. [636] It was not until the advent of the WTO, however, that the SCM Agreement expressly provided in Article 2 an elaborate specificity test constituted of three different progressive stages drawing inspiration from the test developed in US countervailing duty law.

Despite a different historical development, the specificity analysis in both systems seems to be constituted of *three different tests* (or, from another perspective, *three stages of the same specificity test*). Although this is apparent in the sophisticated formulation of Article 2 SCM, Roberti (1997: 200-200) noted that this is essentially true also with respect to EC law. It is therefore justified to analyse the law of both systems simultaneously.

The first, and most straightforward, step of the test is to determine whether the measure is *expressly* addressed to certain undertakings or sectors of the economy, which is usually defined as *de jure* specificity. This concept is enshrined in Article 2.1(a) SCM which provides that the measure is *de jure* specific when 'the granting authority, or the legislation pursuant to which the granting authority operates, *explicitly* limits access to a subsidy to certain enterprises'. [637]

If this is not the case, it is then necessary to focus on the operation and impact of the measure to determine whether it is specific or not. The second step is thus to assess whether the financial assistance is granted on the basis of objective criteria or on a discretional basis.

The fact that the measure is not explicitly targeted at certain undertakings and operates according to objective criteria, however, may not be sufficient to exclude the specificity of the measure if the latter is in fact (*de facto*) capable of conferring an advantage to certain undertakings or sectors. This is the third, and most difficult, step of the test.

The following exposition includes a selection of some of most interesting issues arising from the application of the specificity analysis, in particular with respect to the second and third stages of the test.

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[636] For the EC, see eg Adamantopoulos and Pereyra-Friedrichsen (2001); Van Bael and Bellis (2004: 555 et seq). For the US see eg Jackson, Davey and Sykes (2002: Chapter 18) and Trebilcock and Howse (2005: 275 et seq).

[637] Emphasis added.

In the examination of these issues we will inter alia attempt to examine whether the specificity analysis carried out in the EC on the basis of the short sentence in Article 87(1) EC can be compared with the analysis of the, at least apparently, more sophisticated WTO test. The difference in age of the two provisions may well play a difference, at least insofar as the amount of administrative, judicial and scholarly interpretation is concerned. In particular, the case-law on Article 2 SCM is still extremely limited. If necessary, this difference in experience can however partly, and reasonably, be redressed by considering the interpretations made in US countervailing duty law, which, as said, constitutes the direct model of Article 2 SCM.

## The specificity test between limitation, flexibility, certainty and expansiveness

It has been seen that, in both EC and WTO law, the specificity requirement appears to be a tool to limit the number of measures subject to the scrutiny of State aid/subsidy rules.

We have however also seen that three *inherent characteristics* of the rationales underlying specificity often put into question this general objective of *limitation*. On the one hand, the political/discretional nature of the assessment often implies its *flexibility* and leads to *uncertainty* of results. On the other hand, one of the tendencies of the specificity analysis in both legal systems is its *expansiveness*. [638] As we will see, these *inherent characteristics* can be appreciated in various cases.

### The definition of 'certain' (how many is 'certain'?)

We have seen above that the expressions 'certain' undertakings or enterprises in the Article 87(1) EC and in Article 2.1 SCM immediately seem to point out to a limited

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[638] In the EC Ahlbom and Berg (2004: 51-54) refer to 'an ever-expanding universe'. In WTO law Matsushita, Schoenbaum and Mavroidis (2003: 271) note that the multiple tests of Article 2 SCM 'demonstrate the will of the negotiators to include *a priori* as many subsidies as possible under the term "specific"'. This is particularly evidence by the third step of *de facto* specificity.

scope of the concept of specificity. According to this reading, the impression is that under those provisions a measure is specific if benefits only *few* (if not only *one*) undertakings or sectors.

However, even a superficial examination of the case law leads us to understand that this is not the case and that a measure is held to be specific even though it advantages several undertakings and sectors (to cover even the extreme case that all undertakings and sectors *but* one are touched).

A brief review of the case-law of the Court of Justice may be useful in this regard.

According to the Court, aid for all exports, [639] for a whole sector of the economy or for a region is specific. [640] More recently, it was also made it clear that neither the high number of benefiting undertakings nor the diversity and importance of the industrial sectors to which those undertakings belong warrant the conclusion that a scheme constituted a general measure of economic policy rather than a State aid. [641] Similarly, the Court of First Instance held that a Spanish scheme to assist in the purchase of commercial vehicles by natural persons, SMEs, regional public bodies and bodies providing local public services was specific because large undertakings were excluded. [642] It has even been assumed that financial assistance to the whole manufacturing sector can constitute State aid. [643]

This short review of EC law can be concluded with a very useful definition of Advocate General Roemer which nicely sums up the approach to specificity in the EC. Using a negative formulation, he once suggested that the specificity test would apply to any measure which does *not* apply generally to all the undertakings in a Member State. [644]

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[639] See Joined Cases 6 and 11/69 *Commission* v *France*, paragraphs 20 and 21, Case 57/86, *Greece* v *Commission*, paragraph 8.
[640] See Case 248/84 *Germany* v *Commission*, paragraph 18.
[641] Case C-75/97 *Maribel* paragraphs 32 to 34; cf also Case C-143/9 *Adria-Wien Pipeline*, paragraph 48.
[642] Case T-55/99 *CETM*, paragraph 47. Cf also Case C-351/98 *Spain* v *Commission*, paragraph 40; Case C-409/00 *Spain* v *Commission*, paragraphs48 to 50.
[643] Case C-143/9 *Adria-Wien Pipeline*, paragraph 55. It is interesting to make reference to the practice of the Commission, and in particular to the Irish Corporation Tax case where the Commission changed view on whether support for the whole manufacturing sector was specific. See Ahlborn & Berg (2004: 52).
[644] Cases 6 & 11/69 *Commission* v *France*, at page 552.

It is clear from these statements that a measure may have a quite broad scope of application and may nonetheless be considered as specific. Hypothetically, a strict application of the negative formulation of Advocate General Roemer would lead to consider as specific a measure that applies to all undertakings of the economy *but* one.

A comparable comprehensiveness can be found in the WTO as well. Thus a subsidy to all undertakings in a region is specific (see Article 2.2 SCM). Quite similarly, for export subsidies (and the comparable category of local-content subsidies) specificity is presumed.

This brief examination of the law in the two systems seems to confirm that the definition of specificity is quite wide and can capture many measures that, at an initial reading, seemed to fall outside the scope of the regulation.

## The examples of export and regional aid

It may now be useful to examine two interesting examples of measures that are considered in both systems as specific measures. What will be interesting is to assess the rationale of these conclusion, which, so it seems, can very much be explained in terms of *political economy*.

The first example is that of *export aid*. Export subsidies are considered in both systems as specific. Article 2.3 SCM expressly provides that prohibited subsidies (category which includes both export subsidies and local-content subsidies) are deemed to be specific. Quite similarly, in the EC, the case law of the Court has soon held that export subsidies are specific. [645]

This conclusion is sometimes criticised. Quigley and Collins (2003: 190) have thus wondered why is aid generally granted to all exporting undertakings and sectors regarded as specific, and, conversely, aid to all domestic undertakings is not specific.

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[645] Cases 6 and 11/69 *Commission* v *France*, paragraphs 20 e 21; Case 57/86, *Greece* v *Commission*, paragraph 8

As we will see when the effects of the subsidy are examined, export subsidies (and subsidies assimilated to them) are treated more harshly because they are considered more distorting and more dangerous. Trebilcock and Howse (2005: 276-277) have thus suggested that their intent is more clearly protectionist and, in contrast with domestic subsidies, they are more difficult to explain in terms of legitimate objectives. Further, they are particularly apt to create diplomatic and trade wars.

This may all be true but it does not fully explain why they should be considered as specific. Once again, the serious candidate for their justification has to be found in a *political* decision. Export subsidies (*et similia*) are so dangerous (and difficult to justify) that specificity is somewhat *assumed.*

The issue of whether measures targeted at certain *regions* should be considered as specific has always been rather controversial. The issue was for example subject to great debate in the Uruguay Round negotiations. [646]

It is in particular important to define regional specificity. The following remarks are made with respect to WTO but are similarly valid also for the EC.

Article 2.2 SCM talks of subsidy limited to certain enterprises within the region. This language raises the doubt that, to be regionally specific, a measure should not target all enterprises within the region but only *certain* of them. This doubt is solved with a systemic analysis, by considering the rules on non-actionable subsidies where it is clear that regional measures, which are assumed to be specific within the meaning of Article 2 SCM, can be justified only if they are not specific within the region. It should further be noted that both in the WTO and in the EC regional measures can be justified only if they are not specific within the region. The underlying general idea is that the more specific is the measure the less difficult is to justify it in terms of positive externalities produced (which, as seen above, is controversial in economic circles).

It is clear that regional subsidies are not as such targeted to specific enterprises operating in a certain sector or industry. [647] As Matsushita, Schoenbaum &

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[646] See, eg, MTN.GNG/NG/W/3, paragraph 1.1(b) and MTN.GNG/NG10/W/4, pages 10, 11 and 12.
[647] Moreover, this category of aid is a good example of those measures that are not necessarily addressed at domestic undertakings. Systems of regional aid are often designed to provide incentives for domestic and foreign undertakings alike in order to relocate in the disadvantaged regions.

Mavroidis (2003: 283) clearly note, this could be the case if, for example, a declining region is associated with the production of one good, but, in general, this is not necessarily so.

The tentative answer is that, quite probably, the underlying rationale is based, as Benitah (2001: 260) has suggested, on a simple idea of distortion. A regional subsidy would artificially interfere with the allocation of resources shifting them between regions.

What has to be asked is whether the underlying idea is also the idea of comparative advantage and specialisation of countries/regions. However, Trebilcock and Howse (2005: 3-4) also noted that for an 'unfortunate semantic legacy' from Ricardo's analysis we normally talk of comparative advantage of countries/regions. In fact we should be talking of firms. It seems therefore that this traditional economic theory is – again - particularly relevant is there is a coincidence between region and industry.

Finally, it may be made reference to another distinction which is clearly founded on a political choice (according to our previous analysis in chapter 3, on a constitutional principle). The writer is alluding to the distinction between local measures with local impact on the one side (which should not be specific) and central measures with local impact on the other side (which should be specific). [648] This issue is currently a hot topic in the EC, being subject to the scrutiny of the Court in the *Azores* case.

## Specificity, objective requirements and discretionality

According to Article 2.1(b) SCM, there is no specificity if the granting authority or the legislation establishes objective criteria or conditions on the eligibility for and the amount of the subsidy. These criteria and conditions must be 'objective', which means 'neutral, which do not favour certain enterprises over others, and which are economic in nature and horizontal in application, such as the number of employees

[648] Cf Bacon (1997: 293; Benitah (2001: 260); Wishlade (Chapter 1).

or size of enterprise'. Moreover, they must be 'clearly spelled out in law, regulation, or other official document, so as to be capable of verification', their eligibility must be automatic and they must be strictly adhered to.

A similar conclusion is generally reached in the EC. When aid is granted in accordance with objective, neutral and automatic criteria there is no specificity. Conversely, both legal systems converge in considering that the discretional grant of financial support satisfies the requirement of specificity. [649]

An interesting application of the objective criteria set forth above concerns the support for *Small and Medium Sized Enterprises* (*SMEs*).

The controversy around the specificity of these measures is proved by the fact that, while in the WTO they are not specific, they are deemed to be so in the EC.

Applying the criteria under Article 2.1(b) SCM, and considering in particular the reference to the number of employees and the size of the enterprise, Adamantopoulos & Pereyra-Friedrichsen (2001: 109) have correctly concluded that financial assistance to SMEs would not be specific whereas it would be so, although it could be authorised if it meets certain conditions, in the EC. [650]

Interestingly, the Court of Justice was confronted with the argument that a measure favouring inter alia SMEs was not specific because it satisfied the criteria of objectivity of the SCM Agreement.

The Court roundly rejected the argument

> the fact that the contested aid would not be considered to be a 'specific subsidy' under the Agreement on Subsidies cannot reduce the scope of the definition of aid under Article [87(1)EC]. [651]

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[649] The case law on the point is vast. A classic authority in this regard is Case C-256/97 *DMT*, paragraph 27; for more recent applications, see Cases T-436-348/99 *Territorio Histórico de Álava*, paragraph 51; Cases T-269/99, T-271-272/99 *Territorio Histórico de Guipúzcoa*, paragraph 55.

[650] It is also interesting to speculate that, quite probably, under the SCM aid to large and very large undertakings is more likely to qualify as *de facto* specific than aid to SMEs. Everything however seems to depend on the structure of the market.

[651] See C-351/98 *Spain* v *Commission*, paragraph 44 and Case C-409/00 *Spain* v *Commission*, paragraph 56.

The fact that the measure provides for objective criteria of eligibility does not preclude its classification as specific. The conclusion will be that we are not confronted with an individual aid but rather with an aid scheme or a general aid. [652]

It therefore seems that, in this regard, EC law is stricter than WTO law.

The EC position is not however followed by everybody. Schön (1999: 929) criticized the conclusion that measures targeted at SMEs should be specific since it is not based on the activity of the undertakings but rather on their size. Clearly, this issue is independent from the fact that, due to their special role in the economy and their particular problems, aid to SMEs may find a special treatment when justifications are concerned.

Admittedly, the *explanation* of the classification of these measures as specific remains open. Indeed no recognisable economic foundation can be found. Similarly, there does not seem to be any noticeable *pragmatic* or *political* justification, apart from the will to subject these measures under the scrutiny of EC State aid law. This is a good example where the *discretional* element of the specificity assessment - and its *expansiveness* - comes out prominently.

## De facto specificity

The most interesting step of the test is that of *de facto* specificity which is established when, notwithstanding the appearance of being generally available, the measure at issue is in fact limited to certain enterprises. Thus the *de facto* test does not focus on the legislation *per se* but on the actual disbursements made on the basis of that legislation.

Article 2.1 (c) provides that

> if, notwithstanding any appearance of non-specificity resulting from the application of the principles laid down in subparagraphs (a) and (b), there are reasons to believe that the subsidy may in fact be specific, other factors may be considered. Such factors are: the use of a subsidy programme by a limited number of certain enterprises, the predominant use by certain enterprises, the

[652] Case C-409/00 *Spain* v *Commission*, paragraph 49.

> granting of disproportionately large amounts of subsidy to certain enterprises, and the manner in which discretion has been exercised by the granting authority in the decision to grant a subsidy. In applying this subparagraph, account shall be taken of the extent of diversification of economic activities within the jurisdiction of the granting authority, as well as of the length of time during which the subsidy programme has been in operation.

A footnote to this indent reads that particular consideration will be given to 'information on the frequency with which applications for a subsidy are refused or approved and the reasons for such decisions'.

This test, which also applies in EC law, [653] is often considered as a good example of the expansive trend of the concept of specificity. This may well be true, considering in particular the degree of flexibility required by this factual assessment. It should nonetheless be observed that this expansion seems to be justified if what matters is substance and not form. [654]

***Difficulty of distinguishing between specific and generic measures***

One of the most significant difficulties of the specificity analysis, and in particular of *de facto* specificity, is that it is sometimes quite difficult to determine whether the measure should be regarded as a *general measure* (which is not a State aid or a subsidy) or as a *specific measure* (which may be a State aid or a subsidy). To put the point into an interrogative form: how general is general? Or, conversely, how specific is specific?

This difficulty depends on the fact that virtually all measures have a differential impact and affect the position of some subjects more than that of others.

In both EC and WTO law, however, the existence of a differential impact, which is an inherent feature of almost all measures, does not suffice to conclude that the measure under scrutiny is specific.

Thus the Commission repeatedly made it clear that the fact that some firms or sectors benefit more than others from some measures does not necessarily mean

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[653] Alhborn & Berg (2004: 51-54); Roberti (1997: 201).
[654] See Ahlborn & Berg (2004: 51-54)

that they involve State aid. One of the classical examples concerns measures targeted at labour or capital factor. Measures to reduce labour taxation for all firms have a relatively greater effect for labour-intensive industries, while the reduction of taxation on capital tends to favour capital-intensive industries. In neither case do such measure constitute State aid. [655]

***How to distinguish then?***

We have seen that the existence of a *differential impact* is not sufficient to conclude that the relevant measure is specific.

The big interpretative issue is thus how to distinguish between those general measures, whose differential impact is accepted as an inherent feature, and those measures that, because of their difference in treatment, are sufficiently specific to satisfy the test. [656]

The attentive reader has certainly noted the similarity between advantage and specificity analysis and how the two concepts of general are here playing with each other.

That said, the proposition is that various elements have to be taken into account in the analysis. We can now proceed to indicate those elements that should be taken into account in order to determine whether a measure is *de facto* specific or is rather general.

It seems that the relevant analysis mainly requires two cumulative steps.

The first step, which operates at an objective level, is the *degree of the impact* of the measure. In other words, the *more concentrated* is the *effect* of the measure the *easier* it will be to find it as *specific*. [657]

Clearly, the difficulty of this step is *where* to draw the line. When does a differential impact, which, as we have shown, is virtually present in any measure, become so

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[655] See 1998 Notice on Direct Taxation, paragraph 14; OECD (2001: 157).

[656] There are various controversial examples in the case law. In some cases, the Court found that apparently general scheme in fact produced a partial effect: see Cases 6 & 11/69 *Commission* v *France*, Case 203/82 *Commission* v *Italy*. In WTO law, it is interesting to refer to the Panel, *US - Softwood Lumber IV*, paragraph 7.114 et seq, and to the interesting definition of industry therein.

[657] See Ahlborn and Berg (2004: 51).

significant that the measure should be considered as specific? Conversely, when that impact is not indicative and should not defeat the general availability of the measure?

Whilst it is clear that it is not possible to define arithmetically well-defined ceilings, the foregone conclusion is that it is mainly a case-by-case assessment. In this regard, a valuable guidance may certainly be offered by the consolidation of the relevant practice and case law.

The second step, which operates at a subjective level, is the assessment of the *intent* or objective of the measure. Although we are considering the factual impact of the measure, it is indeed generally recognised that the consideration of this subjective element may play an important role. [658]

The consideration of the intent of the measure may however be subject to two counterarguments.

On the one hand, it may correctly be underlined that, insofar as we are here talking of a *de facto*, ie the factual, objective impact of the measure, the reference to its intent or its objective could seem to be extraneous and, in any event, more appropriate when the *de jure* analysis is carried out which is focused on the explicit purpose of the measure.

Although what matters in the context of a *de facto* assessment is whether, irrespective of its intent, a given measure does produce a differential impact such as to favour only certain undertakings or industries, it cannot be denied that the examination of the *more* or *less clearly stated objective* of the measure may a useful additional element to consider when a complex assessment such as that of *de facto* specificity has to be carried out.

In this regard, it is interesting to refer to the assessment made by the Appellate Body in *Japan Alcohol* in order to determine whether a differential in internal taxation (under Article III:2 GATT) is such 'so as to afford protection'. The Appellate Body noted that

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[658] See, eg, Trebilcock and Howse (2005: 266-268); Roberti (1997: 200).

> although it is true that the aim of a measure may not be easily ascertained, nevertheless its protective application can most often be discerned from the design, the architecture, and the revealing structure of the measure.

Apart from being useful in determining whether there is derogation from the norm, and hence an advantage, in the first place, these criteria can certainly be looked at when the intent of a measure is to be analysed to establish specificity.

On the other hand, what should be avoided – the *leit motif* of the thesis – is the risk of conflating scope and justification.

This is indeed a recurring issue, and a recurrent risk, at virtually all levels of the analysis of State aid and subsidy rules, notably those of the advantage, the specificity, and the effects. We have already seen in the context of the advantage analysis the almost *natural attraction* to consider immediately the objective of the measure and justify it.

In sum, the examination of the criteria considered in the *de facto* analysis has once again shown us that specificity is a *flexible* instrument. *Political* and *discretional* considerations seem to be paramount with the result that the test may well be regarded as *blunt* and at the same time *uncertain* in its outcomes.

One final, interesting issue may be raised. We have seen that the de facto analysis is characterised by an almost inherent unstableness. What should the interpreter do if, after carrying out the previous analysis and assessing the above mentioned factors, he still doubts with respect to the generality or specificity of the measures?

Considering that the burden of proving that an aid or a subsidy is specific is always borne by the complainant or the proceeding national or supranational authority, it seems fair to conclude that, in case of doubt, the measure should be regarded as general. Specificity is one of the constituent elements of the definition of State aid and, generally speaking, also of subsidy (see however Article 1.2 SCM). This conclusion is in line with the consideration that the classification of a government measure of financial support as State aid or as subsidy may produce significant consequences in terms of constraint of governmental prerogatives and/or reaction against private undertakings.

In the EC, it has been suggested that a different conclusion should be reached from a procedural point of view.

Relying on the duty of cooperation of Member States under Article 10 EC, Roberti (1997: 201) has argued that, in case of doubt as to whether the measure is a State aid, the Member State should notify the measure to the Commission and wait for its implementation. [659]

It is interesting to ask whether the same conclusion could be reached in the WTO and its different procedural and institutional framework. Transparency considerations may favour a positive answer. An obstacle to such conclusion may however derive from the risk that the notification might somewhat signal to the other Members the existence of a possible subsidy and trigger unilateral defensive actions against the beneficiary industry.

## 4. Conclusions

The specificity criterion has a mixed rationale. It is partly based on an economic grounding, partly on pragmatic and political considerations. To sum it up, it has been suggested that this is a political economy rationale.

The ambiguity of the rationale results in the flexibility of operation of the specificity test with the end result that the latter is not sufficiently 'specific'.

In both systems the filter is not really selective and the net is in some cases cast wide. Talking about WTO law, and in particular of the various tests of *de facto* specificity, it has wittily been suggested that 'these multiple tests demonstrate the will of the negotiations to include *a priori* as many subsidies as possible under the term "specific"'. [660] This intention is readily captured by Member States in their domestic application of CV duties. [661]

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[659] It is interesting to enquire whether this conclusion is in contrast with the recent reaffirmation by the Court in Case C-71/04 *Xunta de Galicia* that the concepts of aid under Article 87(1) EC and Article 88(3) EC are identical. For a commentary, and a positive assessment, on the point see Ehlermann and Vallery (2006: 710).
[660] Matsushita, Schoenbaum, Mavroidis (2002: 271).
[661] Thus, for example, the EC institutions tend to adopt a very broad interpretation of the notion of specificity: see Van Bael and Bellis (2004: 541).

Although in some cases the interpretations in WTO and EC law may be different, a similar impression derives from the interpretation of the idea of specificity in EC law. This – it may be remembered - has been masterly phrased by Advocate General Roemer and its *negative* formulation whereby the requirement of specificity applies to any measure that does not apply generally to all undertakings in a Member State. [662]

[662] Case 6 & 11/69 *Commission* v *France*, page 552.

# Chapter 5

# Effects, control and remedies

## I. The scope of the chapter

This chapter lays down the last efforts of this research. It builds up on the previous findings on the public intervention in the economy, the advantage and specificity analyses. The subject of the chapter is how the negative and positive effects that subsidies and State aid may produce are assessed and balanced.

This is done in two steps. First, by considering how a model regulation would do this, and secondly by analysing - and evaluating - how the actual legal rules in the two systems do it. Attention is also paid to the two related issues of the systems of control of public subsidies and of the possible remedies against them.

More than in the other chapters, the writer will rely on the, sometimes not fully clear, findings of other disciplines, particularly *economics* and *political science*. This analysis will provide good food for thought for the actual legal analysis of the current regulation of WTO subsidies and EC State aids and its critique.

The exposition will follow this pattern. After a section introducing the main traits of the economics and politics of public subsidies, the analysis focuses on the rules on effects, control and remedies in the two legal systems. A final section will provide the conclusive remarks.

The reader should immediately be warned however that he will not find a comprehensive analysis of the *law* on the effects in the two systems. The area is vast, particularly with respect to the regulation of the justifications. In the EC it is further currently subject to a major overhaul, of an intensity that the EC has probably never seen in his fifty years of life. What the writer aims to do is to go beneath the technicalities of all the (existing and *in fieri*) disciplines of the various justifications and detect the underlying trends. And, eventually, to assess them against the model theoretical framework of the first part.

## II. The economics and politics of subsidies and State aids

This section is truly interdisciplinary. When it comes to analyse the effects of public subsidies, their control and the remedies against them, the lawyer (and the writer is no more than that) needs to draw inspiration from the teachings of other disciplines, most notably *economics* and *political science.* [663]

The following paragraphs are the result of the personal synthesis – always through a legal lens - of what are regarded as the most interesting findings of these two sciences. Building up on these findings, and on those of the analysis of the previous chapters, the ultimate purpose is the attempt to lay down the main traits of what an appropriate – a model - regulation of public subsidies should be and to test the current WTO and EC rules against this model.

It should be anticipated that, far from having the presumption of providing a ready-made solution, the writer attempts to draw from the debate on public subsidies in various circle. The stimuli derived from the dialogue with *other* experts and their personal perspectives are always thought-provoking and contribute to a better understanding of the subject. In this sense, with its curiosity and lure for exploration, a *multi-disciplinary* approach goes hand in hand with a *comparative* one.

Unfortunately, despite these interesting wanders, the result is that, in many cases, the writer cannot offer more than tentative answers. The constraints posed by reality have further to be duly taken into account. Thus, quite often, second (and even third) best solutions are put forward.

### 1. The concept of distortion

One concept is crucial when it comes to talk of the effects of subsidies and State aids, of their control and of the remedies against them. This concept, which is one of the true paradigms in the field, is that of *distortion.*

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[663] Which are sometimes considered together by the discipline of *regulation.* See Baldwin and Cave (1999: 1).

Before analysing it, it may be useful to begin with the brief examination of the difference, and interplay, between the three basic notions of *market*, *trade* and *competition*.

## Starting from the basics: the notions of market, trade and competition

The *market*, which may be domestic or international, is the place where trade and competition occur. Whereas *trade* is about the circulation of productive factors, and in particular of goods and services within the relevant market, *competition* may be viewed as the process whereby those goods and services, and ultimately their suppliers, struggle with each other to strengthen and extend their position within that market. [664]

Firms, industries - and even countries - compete with each other through (international) trade. Without the possibility of trading, ie of putting products and services on the market (either domestically or by exporting to other countries), there would be no competition.

In a word, competition occurs through trade in a market.

The generally accepted opinion is that, through trade and competition, market forces would *naturally* lead to the best, in the jargon of economics *most efficient*, allocation of resources, thus maximizing the benefit – technically the *welfare* - of society. [665] More tangibly, this should be represented by lower prices, better products and services, wider choice and greater efficiency. This optimal result would derive from the unconstrained functioning of, even conflicting, market forces. This belief is exemplarily summed up in the image of the 'invisible hand' forged by Adam Smith in the 18th century.

The other side of the story is that all this may occur only in presence of certain conditions (such as an indefinite number of agents, perfect information and no

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[664] This definition has been shaped by the writer. For similar notions see OFT (2004: para 3.4); Whish (2003: 2). In fact various definitions of competition have been formulated. For an interesting review of the economic literature, and a proposal, see Nitsche and Heidhues (2005: 44-47).

[665] In the economics jargon, this situation, called 'Pareto efficiency', is that in which no feasible change can raise anybody's welfare without lowering that of somebody else (Black's Dictionary of economics (2002: 343). For a clear exposition of 'Pareto efficiency', and its implications for State aid law and policy, see Friederiszick, Röller and Verouden (2006: 12).

governmental intervention) which are rarely present with the result that the market often fails to deliver its promised benefits. In a word, it does not function efficiently. Further, even when market forces reach an *efficient* allocation of resources, this may not be considered *equitable.*

Despite these failings, which are addressed by various forms of public intervention in the market (including public subsidies), the idea of competition remains an accredited paradigm.

It is vital to appreciate how firms behave in the market. It is crucial to understand international trade, and the underlying rationale based on specialization and comparative advantage. [666] Finally, as the following of the analysis attempts to explain, it is pivotal to make sense of how firms may be advantaged or disadvantaged by public subsidies.

## Distortion of public subsidies: the 'hunt' for a definition

The Black's Dictionary of economics (2002: 125) define distortions as 'economic situations in which the incentives facing firms and individuals fail to reflect true social opportunity costs'. For is part, a social opportunity cost is 'the amount of goods which has to be forgone because resources are used to make some particular good. When any goods or services are produced, the resources used to make them are not available for other purposes'. [667] In simpler words, distortions create a misallocation of resources because they induce firms to act in a certain, undesired, way. When it finally comes to identify the causes of distortions, the conclusion is vague: 'distortions can be created by externalities, taxes, or monopoly'. [668]

This concept of distortion itself is still very general. When applied to the public intervention in the economy it can even become ambiguous. Professor Jackson (1997: 298) noted that 'in some sense, every governmental action that impinges on the economy creates a "distortion"'.

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[666] See, inter alia, Sykes (1989: 209).
[667] Black's Dictionary of economics (2002: 434).
[668] Black's Dictionary of economics (2002: 125).

The distortions that may be produced by public subsidies may be various, and may substantially be summed up in various forms of inefficiency. [669] Economics and management science teach that public subsidies may lead to *allocative* inefficiency (if resources are not used in the best possible way), *productive* inefficiency (if goods and services are not produced at least cost), *dynamic* inefficiency (if firms are encouraged to undertake the wrong amount/type of innovation, for example research and development), and *X*-inefficiency (when public support induces opportunism in the firm's management and workforce and hence to reduced productivity). More prosaically, all this seem to result in a waste of public money.

What has to be asked is whether, from the operative point of view, a more workable concept of distortion can be identified as the main *catalyst* of many, if not all, of the forms of economic inefficiency outlined above. This concept would be the direct and immediate focus of any regulation of public subsidies.

## Developing the definition: simple v sophisticated view

A big debate on the basic notions, including that of distortion, arising from subsidy rules under the GATT took place in the North-American scholarship between the 1970s and the 1980s. [670] More recently, Benitah (2001: 251-280), id (1996) has identified two ideas of distortion which would confront with each other in the GATT/WTO law and in the relevant doctrinal debate. Although this distinction has been predicated with particular regard to WTO subsidy rules, and especially in the context of a countervailing duty action scenario, his conclusions are of more general application.

The *simple* view of distortion would rest on the subsidy's interference with the "natural" market mechanism governing the allocation of resources in the subsidizing country and subsequently with a disturbance of international economic

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[669] The following exposition draws from various sources. Some references stand out: Roberti (1997: chapter 5), Whish (2003: 2-4), Gore (2005).

[670] See, eg, Schwartz and Harper (1972); Barceló (1977); Goetz, Granet and Schwartz (1986); Diamond (1989a); Sykes (1989a). The 1980s were closed by a Symposium of the Countervailing Duty Law at Georgetown University Law Centre in 1989. The relevant contributions touch the main concepts and rationale of subsidies and countervailing duty response. See Schwartz (1989); Diamond (1989b); Cass (1989); Eskridge (1989); Sykes (1989b); Trebilcock (1989); Jackson (1989). For three more recent contributions see Sykes (1997), Cass and Knoll (1997), Boltuck (1997).

relations. Clearly, the standard of proof of this simple view is not very demanding and many subsidies would be found to match it.

There would also be more *sophisticated* views of distortion. One of the most accredited, which refers on the 'effects on rivals', rely on the impact of the subsidy on the cost/revenue structure of the recipient. This would cause a change of the latter's behaviour and could lead to adversely affect the position of competitors.

In the context of countervailing duty actions, this is phrased as harm to the 'entitlement' of the competing industry. [671] Diamond (1989a: 784-785) lucidly explains this impact:

> [f]or a payment to have this effect, it must lead the [subsidized] firm either to increase the quantity of goods offered or to decrease the price it charges in [foreign] market[s]. Because the recipient firm will produce until marginal revenue equals marginal cost, a payment will only have such a detrimental impact if it either decreases the marginal cost of the foreign producer or increases its marginal revenue. Unless this occurs, the government payment may increase the profits of the foreign firm, but no need for a countervailing duty will exist.

Leaving aside the reference to countervailing duty (the debate has to be set in its context: i) the interpretation of Tokyo Subsidy Code where, despite advances, the strongest track was still the unilateral one, and ii) in a country – the US – which have by far been the strongest users of countervailing duties), the economic proposition is clear. Since an efficient firm will produce only until marginal revenue *equals* marginal costs, we cannot talk about a distortion, and we should not be concerned, unless the subsidy favourably interferes with one of these two variables. Hence it should either reduce the marginal cost of the recipient (cost-saving subsidy), or increase its marginal revenue (revenue-increasing subsidy). [672]

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[671] The 'entitlement' language has first been used by Goetz, Granet and Schwartz (1986: 18-19). It is useful to quote the relevant passage *in extenso*: 'We assume that American firms are entitled to that domestic market outcome which would have resulted from a "fair", competitive process, by which is meant one which has not been "manipulated" by foreign government subsidization. The idea then is to restore competition in the American market to its "but for" state by neutralizing the effect of the subsidy'. The 'entitlement rationale' of countervailing duties has been developed by Diamond (1989a), (1989b), and criticized by those relying on efficiency arguments: see, eg, Sykes (1989b). For a more recent critical review of the 'entitlement approach' see Trebilcock and Howse (2005: 287-288).

[672] The concepts of marginal cost and marginal revenue respectively refer to an additional increase in cost and revenue for an increase of an activity. Cf Begg, Fisher, Dornbush (1997: 98).

It is *only this* impact on the cost/revenue structure that is eventually liable to have a troublesome effect, in a word to distort competition, because it significantly interferes with the determinants of an efficient firm's conduct. In other words, any improvement of the market position of the recipient which does not produce the said impact but simply enhances it with respect to the situation before the grant of the subsidy cannot interfere with the behaviour of the recipient and hence with competition. [673]

Clearly, if compared with the simple approach, the sophisticated view of distortion requires a thorough case-by-case economic analysis of the impact of the subsidy and is consequently more demanding from the evidential perspective. This point is thoroughly examined below.

It should be made it clear that the writer does not conclude that one view is better than the other. The assessment is more nuanced.

Whereas the simple view of distortion is particularly suitable to explain certain elements of the definition of subsidy, such as the advantage or specificity analyses, which are there to merely capture the *potential* to distort, the sophisticated view is more appropriate when it comes to ultimately determine the economic impact of the subsidy, its system of control and any remedy to tackle it. At this level, it seems indeed that what should really matter is whether the subsidy *actually* produces an advantage for the beneficiary which is liable to negatively interfere with its competitors' positions.

What is ultimately required is therefore a *distortion* of *competition*.

## The 'quarry': distortion of competition

The hunt has eventually found its quarry. The concern raised by public subsidies is that they may result in a *distortion* of *competition*.

Although there is a significant debate about whether a competition assessment should also take into account of the interests of other stakeholders, particularly consumers and taxpayers, there seems to be a certain agreement that what directly, if

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[673] Alhborn and Berg (2004: 49-50).

not exclusively, matters under a system of control of public subsidies is a significant interference with the *competitive process between undertakings*. [674]

Considering its importance, it is worth repeating the core of this economic (and legal) proposition, borrowing this time from a clear definition of Beviglia-Zampetti (1996: 24) forged in the context of the WTO:

> What would be important to prove is that the subsidy has indeed provided the recipient firm or firms with an artificial competitive advantage, affecting its cost and revenue structures, and that this action has distorted the normal competitive process, resulting in injury to the domestic industry.

A model regulation of public subsidies should principally aim to 'control' these distortions of competition. What has to be ensured is that public subsidisation does not *damage* more efficient undertakings to the benefit of less efficient ones.

It is finally worth noting that the standard to assess the distortive potential of public subsidies underlying this reasoning is constituted of 'a pragmatic notion of "normal competition" or the "normal competitive process"' [675] or, with another expression, 'a prosaic theory of workable competition'. [676]

Although these formulations are a realistic recognition that conditions of perfect competition are rare to be found, they should be distanced from the blurry concept of 'fair competition' which is often used to justify subsidy rules, and in particular the unilateral reaction to them (ie countervailing duties). [677] As private interest theories, such as 'public choice', [678] would probably explain, the blurred notion of 'fair' competition is the evocative - often more voiced than explained - mantra of lobbying industries seeking protection. The problems come when it is necessary to

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[674] With some inevitable differences in emphasis, this is substantially confirmed by a review of the, mostly economic, literature. See, eg, Alhborn and Berg (2004); Benitah (2001); Beviglia Zampetti (1996), Fingleton, Ruane, Ryan (1998); Frontier Economics (2004); Gore (2005); Low (2001); Friederiszick, Röller and Verouden (2006: 12); Nitsche and Heidhues (2005: 44-47); OFT (2004: para 3.4); OFT (2005).
[675] Beviglia-Zampetti (1996: 24).
[676] Whish (2003: 14).
[677] See Messerlin (1999: 181) who suggests that the 'adverse effect approach' of the SCM Agreement would rely on this notion which would not correspond to the test of distortion of competition of the EC Treaty.
[678] This theory emphasize the force of private interests in capturing governmental decisions. A nice exposition has been made by Baldwin and Cave (1999: 21-25).

make this concept operational and to give it substance. [679] This distinguishes the concept of 'fair' competition from those of 'normal' or 'workable' competition that combine realism with a more solid anchorage to theory.

The crucial step in this chapter will be to assess whether and how this economic proposition does, or could, find support in the actual regulation of public subsidies in the EC and in the WTO.

## Distortions across the border

From an international perspective, subsidies should matter only if they produce distortions or externalities across the border. [680] Accordingly, any supranational regulation of public subsidies should target only those measures that are liable to produce such distortions. [681]

This 'across the border' effect can generally be proved quite easily for export subsidies. There is indeed a general acceptance that this aggressive measure of industrial policy, which cannot be easily justified but can easily create international tensions, reduce global efficiency. A potentially troublesome international impact can also be produced by domestic subsidies which may have the same effect of a tariff or a quota and empty trade liberalization, although the proof of an externality across the border may be more demanding.

An economic reality which should be taken into due account is that, in an increasingly liberalized and globalized economy, it is easier that a public subsidy - and indeed any public or private economic action - produce a distortion across the border. This is simply the result of the widening and integration of markets, ie of the places where competition and trade occur. Further, the distorting effect of subsidies is magnified as other governmental distortions are eliminated. From a

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[679] A comprehensive critical overview of the 'fairness rationales' of countervailing duty laws is made by Trebilcock and Howse (2005: 283-285).

[680] Besley and Seabright (1999: 21); Friederiszick, Röller and Verouden (2006: 22); Jackson (1997: 299); Pelkmans (2001: 241).

[681] Although rare, it is worth noting that there are examples of domestic control of public subsidies where the distortions under scrutiny are by definition limited within the boundaries of the national jurisdiction (this is the case of Denmark: see OECD (2001: 21-22, and 93-124 for a detailed exposition of the Danish model); see also http://www.ks.dk/english/stateaid/, last visited on 13th July 2006). Generally, there is an increasing awareness on the national role in the design and control of any public subsidies. For the example of the UK see OFT (2004: chapter 5) and Vickers (2005) who lapidarily suggests that 'scrutiny should begin at home'.

political economy perspective, this purely economic justification may be reinforced by objectives such as the creation or strengthening of an internal market. [682]

What is however clear is that the determination of whether there are distortions across the border should eventually rest on the assessment of the actual impact of the subsidy on competition.

## The assessment of the impact on competition

The crucial finding so far has been that the determination of a distortion of competition which produces cross-border externalities is the core of the analysis of the negative effects produced by public subsidies.

It has been underlined that this distortion should be interpreted in a sophisticated manner, which focuses on the effect of the subsidy on the conduct of the recipient, which usually depends on an impact on its cost/revenue structure, and on the subsequent effect in the relevant market.

It has also been anticipated that this assessment may be particularly complex.

Two main dimensions need to be considered, first the *subsidy characteristics*, secondly the relevant *market characteristics*. [683]

### *Subsidy characteristics*

The subsidy characteristics refer to the type and amount of the measure of financial support and to its impact on the said cost/revenue structure of the recipient. With respect to the latter element, it has been said that generally reference is made to *marginal costs*. As Trebilcock and Howse (2005: 287) noted 'measuring marginal costs is a notoriously difficult exercise, exacting in its data demands and inherently error-prone'. [684] Consequently, the proxy of *variable costs* is often used, but in many cases this does not yield accurate results. [685]

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[682] Evans (1997: 80 and 105-106); Friederiszick, Röller and Verouden (2006: 26-27);
[683] OFT (2004: paras 3.33 and 3.34). See also Friederiszick, Röller and Verouden (2006: 44-47) who mention as a separate element the procedural aspects of the granting decision.
[684] In this regard see also Frontier Economics (2004: 35).
[685] Frontier Economics (2004: 35); Trebilcock and Howse (2005: 287).

The assessment of costs is a difficult exercise. Leaving aside the issue of their accuracy, variable costs (such as labour and raw materials) directly affect pricing and output (as well as entry and exit) decisions of firms since these depend on the level of production.

It is not only variable costs that should be taken into account however. Although to a lower degree, a reduction of fixed costs, which do not depend on output, may also distort competition because it may enable the firm to continue in the market. [686] Fixed costs (eg factory, machinery) do not affect pricing and output decisions but they have an influence on entry decision, and, in the long run, may act on exit decisions. [687]

To complicate things further, it is recognized that it is often difficult to distinguish between variable and fixed costs, and to identify whether a subsidy will affect fixed or variable costs.

***Market characteristics***

The assessment of market characteristics is complex too. It should be immediately noted that a necessary, but not sufficient, prerequisite for the public subsidy at issue being liable to produce a distortion to competition is that the market is neither monopolistic nor perfectly competitive. [688]

Friederiszick, Röller and Verouden (2006: 45-46) suggests a list including factors such as the size or market share of recipient; the asymmetry of market shares; barriers to entry; the degree of product differentiation; the complementarity with neighbouring markets; the segmentation of markets between Member States; the tradability of the goods and impact on location choices.

Finally, a crucial prerequisite of the market analysis is the previous definition of the relevant product and geographical market. Although inspiration can be drawn from other areas of the law, such anti-trust law, where such an exercise is usually made,

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[686] Fingleton, Ruane, Ryan (1998); Ahlborn and Berg (2004: 48-49).

[687] If they are not sunk. See Frontier Economics (2004: 18-20); Gore (2005); Nitsche and Heidhues (2005); OFT (2004: paras 3.14-3.24).

[688] For a clear explanation of this point see Besley and Seabright (1999: 21); Pelkmans (2001; 242).

economic literature underlines that this issue is different in the case of public subsidies and the necessary adjustments should be made. [689]

### *Counterfactual and de minimis*

We can conclude the analysis of the competitive assessment with two remarks (which have more a political and legal rather than economic flavour).

First, the counterfactual that may be used to determine whether the subsidy produces a negative effect is based on the competitive situation before the public intervention.

This crucially means that the assessment of the negative effects produced by subsidies should not take into account the fact that they tackle a disadvantage or *any* another distortion in the economy (this point is discussed further below when we analyse the positive effects of subsidies and their balance with the negative ones).

At a more general level, this is a recognition of the *limited* role played by a regulation of public subsidies which do not aim to approximate the different regulatory frameworks and the relevant competitive advantages/disadvantages of the various countries. All this should be discounted from the assessment, which simply focuses on whether, under the existing economic conditions, the public intervention is such as to interfere with the costs/revenues of the beneficiary firm or industry and to damage more efficient competitors.

The second remark is that many legal systems, including WTO subsidy and EC State aid rules, feature a concept of *de minimis*, which operates as a sieve to exclude from the scrutiny those distortions that are considered to be minimal. Although blunt, from a pragmatic perspective, this tool may be appropriate, particularly, but not only, when the system of control is centralized and preventive. It is a useful instrument to dispose of the petty distortions and concentrate the limited administrative and judicial resources to tackle the most troublesome ones.

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[689] See Alhborn and Berg (2004); Fingleton (2001); Fingleton, Ruane, Ryan (1999), id (1998).

## A legal finale: State aid and subsidy rules as competition regulation

In this paragraph, the writer returns for a moment to familiar territory. The issue discussed here is inherently a legal one.

The interesting consequence of the previous reasoning is that, not only State aid law, but ***also*** WTO subsidy law should be regarded as a *competition*, rather than a *trade*, regulation.

This is not only a recognition that the *policies* of trade liberalization and competition are inextricably linked with each other. [690] It is not even a recognition of the increasing convergence, even in language, between trade and competition *rules* which we assist in both legal systems. [691]

It has, for example, been underlined that the 'rule of non-discrimination in WTO law (effectively a free-trade rule) contains a clear undistorted-competition element'. [692] Reference is made to Article III GATT on national treatment and to its interpretation as a legal tool aiming at 'equality of competitive conditions'. [693]

If the attention is now moved towards one of the partial equivalents of the GATT provision in the EC Treaty, Article 28 EC, it does not need much effort to find statements which go towards the same direction. Biondi and Eeckhout (2004) have advanced that the 'emphasis on market access may lead to references to undistorted competition' and what is a required is 'but a small step'. In this case, the authority suggesting this 'step' has been Advocate General Jacobs' analysis in *Leclerc-Siplec* where he mentioned the guiding principle

> [t]hat all undertakings which engage in a legitimate economic activity in a Member State should have unfettered access to the whole of the Community market, unless there is a valid reason for denying them full access to a part of that market. [694]

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[690] Ehlermann (1992: 257) has thus clearly underlined the interplay between EC competition policy and Internal Market policy.
[691] See, eg, Biondi and Eeckhout (2004); Mortelmans (2001); O'Keeffe and Bavasso (2000).
[692] Biondi and Eeckhout (2004: 105).
[693] Appellate Body, *Japan – Taxes*; id, *EC – Asbestos*, paragraph 97.
[694] Case C-412/93 *Leclerc-Siplec*, paragraph 41 of the Opinion.

Two other notable examples of the convergence between the two areas of EC law can be made. One is the *Tobacco Advertizing Directive* case where the Court, in interpreting Article 95 EC, which empowers the Council to adopt harmonization measures for the establishment or function of the internal market, found that such measures must genuinely contribute to such objective. In particular, they must either contribute to eliminating obstacles to free movement or they must purport to eliminate an appreciable distortion of competition. [695] As a result, the removal of distortions of competition is one of the bases for adopting legislation under Article 95 EC.

The other is the *Wouters* decision which has clearly shown a convergence between Articles 81 and 82 EC on the one side and free movement rules on the other, particularly at the level of the operation of the justification. [696]

More specifically with respect to State aid law, the analysis of the case-law on the relationship between free movement and State aid rules, has led Biondi and Eeckhout (2004: 108) to formulate this sweeping conclusion:

> [t]he assumption upon which the entire reasoning is based is the recognition that both sets of rules are pursuing an *identical* aim, namely that of ensuring the free movement of goods under normal conditions of competition. [697]

This powerful language that reveals the (alleged) identity of aims between State aid and internal market law has been taken on board by Friederiszick, Röller and Verouden (2006: 27).

Another important common denominator between trade measures and State aid is that their actor is public and a public policy objective is always the underlying rationale. [698]

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[695] Case C-376/98 *Germany* v *European Parliament and Council.*
[696] C-309/99. This case has sparked a lively debate. Cf, eg, Monti (2002).
[697] Emphasis added.
[698] The intriguing issue of the role played by public policy objectives under Article 81 and 82 EC has come out prominently in the *Wouters* case where the crucial point was the fact that, in substance, there has been a delegation of public regulatory powers to the Dutch Bar.

In our view, however, strictly speaking, it is better to talk of *complementarity* rather than identity. Generally, both sets of rules are clearly going in the same direction, that of the *liberalization of the economic forces of the market.* As O'Keeffe and Bavasso (2000: 543) noted

> the aim of creating an internal *market* constitutes a unifying thread or, at least, an interface between EC internal *trade* law and EC *competition* law. [699]

If the target is the same, the duties are different. As advanced at the beginning of this chapter, *competition* occurs *through trade* in a *market.* Reformulating the finding of O'Keeffe and Bavasso (around the three emphasised terms), the goal of creating a place (ie the *market*) where *competition* and *trade* could occur is certainly the connecting link between the two disciplines.

That said, however, the writer's understanding is that, like free *trade* is the prerequisite of *competition*, so, conceptually speaking, trade law should be distinguished from competition law.

What however leads the writer to propound for distinguishing is a stronger operational divergence. There is indeed a crucial difference in the *working* of these two forms of regulation. Unlike trade rules, competition rules are largely based on an assessment of the effects of the private or public conduct at issue on undertakings and on the market. This analysis enquires the impact of competitive relationships and significantly (and increasingly) rests on economic analysis.

As it is indicated by their language and by their position in the EC treaty (in Chapter 1 of Title VI on the 'rules on competition'), State aid law is admittedly a competition regulation. It focuses on the effects on competition of State subsidisation and is largely, and increasingly, grounded on economic analysis.

Some doubts could be raised with respect to WTO subsidy rules. Subsidies are generally regarded as obstacles to trade. Moreover, it is generally observed that, apart from some notable exception (see, for example, the Articles VIII and IX GATS), WTO law would not substantially include competition provisions.

It is however submitted that, whereas it may be true that subsidies and State aids can *also* be viewed as barriers to trade, and that WTO law does not (yet) provide for any traditional antitrust law (ie for a regulation of the anti-competitive conduct of private undertakings), if we consider the *distinguishing element* between trade and competition regulation suggested above - the execution of an effect based analysis of the measure relying on a thorough economic analysis of its impact on competitive relationship -, it seems that WTO subsidy law is more appropriately regarded as a competition rather than a trade regulation. [700]

At the end, more than a conceptual nicety, it is a practical difference that matters.

***Case-study: the effect on trade between free movement and State aid in EC law***

EC law provides us with an interesting debate which, for its obvious link with the previous paragraph, the writer believes appropriate to anticipate here.

O'Keeffe and Bavasso (2000: 544) have detected the 'common ancestry of competition and free movement' in the fact that both rules are 'subject, albeit in different forms, to an assessment of the effect on trade between Member States'. Whereas this element, expressly worded in competition (both antitrust and State aid) rules, has traditionally been interpreted as a *jurisdictional* test, the effect on trade would obviously represent the *substance* of free movement rules.

The writer's proposition, however, is that the effect on trade should be interpreted *both* as a *substantive* and as a *jurisdictional* test not only with respect to free movement, as has been convincingly explained by O'Keeffe and Bavasso (2000), but also in the area of State aid.

It is known that the requirement of an effect of trade between Member States under Article 87(1) EC has also been quite easy to prove. More interestingly, it has often happened that this element has been treated together, somewhat merged, with the distortion of competition test. The simplified competition analysis has thus

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[699] Emphasis added.

inevitably meant a simplified effect on trade test. A fundamental step in this direction has been made by the Court in the *Philip Morris* case. [701] The crucial finding is that, once the position of an undertaking active in Community trade is 'strengthened', an effect on trade should almost invariably be assumed.

There is indeed an inevitability in considering the distortion and effect on trade together. This argument pertains to the *substantive* nature of the effect on trade. It has been seen that, from an economic perspective, an appropriate discipline of public subsidies should be concerned with the actual effects created by the latter. In this regard, the execution of a full, and sometimes complex, economic market analysis is required. Since we are dealing with a supranational regulation of subsidies, the concern should the detection of distortions across the border.

It is argued that, in the context of Article 87(1) EC, this is the *substantive* role played by the effect on trade element. This has been implicitly recognised by a recent work of Ehlermann and Vallery (2005: 711) where the link between the establishment of an effect on trade and a 'market analysis' whereby the 'relevant geographic and product markets must first be defined' has been expressly made. As has been clearly underlined, this however requires a serious analysis which should not rely on 'negative' and 'vague' statements such as that an effect on trade is 'not inconceivable'. [702]

To repeat the point, at a *substantive* level, the element of the effect on trade is strictly linked to that of the distortion on competition because, to trigger the application of State aid rules, what has to be proved is that a distortion of competition across the border has occurred or is threatened.

This is the first step to give full meaning to the effect on trade element.

Although not fully separate from the distortion of competition from a substantive point of view, the *effet utile* of the effect on trade element would also be safeguarded in another way, ie by redefining its *jurisdictional* function. As suggested by

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[700] Along these lines of reasoning it is interesting to note that, already the Tokyo Subsidy Code spelled out expressly that subsidies may 'adversely affect the conditions of normal competition' (Article 11.2). This terminology did not have much success in the drafting of the trade-impact standards of the SCM Agreement.
[701] Case 730/79.
[702] See Case C-172/03 *Heiser*, paragraph 35 ('not inconceivable'); Case C-71/04 *Xunta de Galicia*, paragraph 47 ('conceivaible').

Ehlermann and Vallery (2005: 712) this should be done by considering it as an 'appropriate filter'. From an operational standpoint, this means that, even at the very preliminary stages of the investigation, it may immediately be apparent that the measure under scrutiny cannot have an impact going beyond the domestic borders and should therefore be immediately disposed of.

Quite intriguingly, a similar argument has been put forward in the WTO context by Jackson (1997: 298-299) who suggested introducing a 'distortion across the border' test as a 'pre-requisite'. Its functionality, very similar to the 'filter' image put forward in EC law, would be to dispose of the clearly non-troublesome subsidies at the preliminary stages of countervailing duty investigations.

This redefinition of the effect on trade element leads us to reconsider the role of a *de minimis test* in State aid law. This filter is commonly used by the Commission and has recently gained a legislative recognition [703] The even recent case-law, however, seems to show a steady resistance to accept it, albeit often with some ambiguity (whereas the Council and Commission legal instruments are mentioned, they are either found to be inapplicable on the facts of the case or the traditional case-law position is reiterated without affecting the legal principle of *de minimis*). [704]

A parallel with the law on free movement may again be useful. The traditional approach is that there would be no *de minimis* rule. The *Keck* judgment has however kicked off a process of debate and rethinking about the rationale and working of internal market rules. [705] A landmark in this process is represented by the market access test proposed by Advocate General Jacobs in his Opinion in *Leclerc-Siplec* which also features a *de minimis test.* This test has found some indirect support in the

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[703] See Council Regulation 994/98 (the so-called 'enabling regulation') and the subsequent block exemption, Commission Regulation 69/2001.

[704] For the first type of cases (mention of *de minimis* rule but inapplicability on the facts) see, eg, Case C-382/99 *Netherlands* v *Commission*, paragraphs 37 to 39 where the Court analyses the compliance with the Commission Notice. Compare with Case T-453/99 *Kuwait Petroleum*, paragraphs 71 and 72 which, on essentially the same facts, they CFI do not address the *de minimis* point at all.
The second type of cases, where the Court ambiguously mentions the *de minimis* instrument but at the same time reaffirm its own case-law without giving any judgment on the former, see, eg, Case C-280/00 *Altmark*, paragraphs 80 and 81; Joined Cases C-34/01 to C-38/01 *Enirisorse*, paragraph 28; Case C-172/03 *Heiser*, paragraphs 32-34; Case C-71/04 *Xunta de Galicia*, paragraph 41.
For a commentary of the *Heiser* decision see D'Ormesson and Bouin (2005), of the *Xunta de Galicia* decision see Ehlermann and Vallery (2005).

[705] Cases C-267-268/91 *Keck*. See Weatherill (1995).

case-law [706] and seems to increasingly gain support in the literature. This test is conceptually sound. It certainly may involve some practical difficulties but no more than those encountered in the antitrust field. [707]

The question that should be posed is: why is the Court still so reluctant in accepting it in State aid law? Our submission is that an acceptance of the *de minimis* test would also be in line with the rethinking of the proper role of the effect on trade test outlined above.

A word of conclusion: the previous analysis involving i) a redefinition of the effect on trade requirement and ii) a defence of the *de minimis* rule, is fully in line with the current trend in EC State aid law and policy which aims to combine a more effects-based approach with an efficient administration of the rules. [708]

## Three case-studies on the concept of distortion of competition

Three case-studies are used to explore the complexities of the concept of distortion of competition. The first focuses on the issue of mobile investment and regulatory competition, the second on the compensation of regional location costs, and the final one on the relationship among public subsidies, competition and consumer welfare.

### a) Mobile investment and location competition

In their both deep and accessible paper Friederiszick, Röller and Verouden (2006: 42-43) set forth four types of distortions of competition that State aid may cause. The first three can easily fit the previous analysis (i) reducing effective competition by supporting inefficient production, ii) reducing effective competition by distorting dynamic incentives, iii) reducing effective competition by increasing market power –

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[706] See Case C-67/97 *Blume*.

[707] O'Keeffe and Bavasso (2000: 552).

[708] The more general reference is certainly the State Aid Action Plan (2004). Mention should also be made to the Decision and the Framework on the application of Article 86(2) EC to public service compensation (2005), and to the draft Communications for the assessment of lesser amounts of State Aid (LASA) and of State aid which has limited effects on intra-Community trade (LET) (2004).

exclusionary practices). The fourth is however the most intriguing: distorting production and location decisions among Member States.

As the authors expressly clarify, whereas the first three 'theories of harm' relate to the impact on competition between firms, the last one more specifically refers to the impact of aid on competition between Member States.

This type of distortion refers to the cases where Member States grant subsidies to firms to influence their location decisions. Governments are, or may enter, somewhat in competition between them to attract mobile investment (capital is for example a mobile resource).

The economic efficiency of this practice is hotly debated. It certainly involves a sophisticated approach towards the possible distortions that it may cause.

On the one side, OECD (2001: 38:30, 180) argue that these incentives would not create any problem in presence of certain conditions, particularly if they apply in a non-discriminatory manner (in other words, they do not discriminate according to location or ownership) and there are no barriers to the movement of firms. [709] In presence of these conditions, there would be no distortion to competition. [710] This conclusion is supported by referring to Besley and Seabright (1999: 36) who interestingly seem to argue with respect to 'greenfield' investment (ie 'new' investment). Finally, Groeteke and Heine (2004: 331) underline the benefits that locational competition may have on institutional rigidities, with the result that they end up talking of 'institutional competition' between Member States. [711]

Others draw more clearly distinctions. Pelkmans (2001: 242) underlines that there is a difference between 'greenfield' investment and relocation of existing resources. Whereas aid to induce the latter would create negative cross-border externalities, the question would be more open with respect to the former.

The position of the EC is traditionally negative and is concerned that competition between governments might endanger regional cohesion, and this naturally to the

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[709] Cf also Hufbauer and Erb (1984: 105 and 107).
[710] OECD (2001: 170).
[711] In particular, far from being a justification for State aid intervention, the presence of 'institutional rigidities' should be solved by opening up competition between Member States: Groeteke and Heine (2004: 328-330). This point is discussed below when the justifications are dealt with.

detriment of poorer regions. [712] Friederiszick, Röller and Verouden (2006: 18) argue that the 'efficiency property' pointed out by Besley and Seabright (1999) works only in presence of certain circumstances, ie 'when countries are not resource constrained. If this assumption is not fulfilled, poor countries will easily outbid reach countries.' Speaking more generally (2006: 43), they highlight the risks of these incentives in terms of 'inefficient production structure throughout Europe', 'negative spill-overs for other Member States when the good or service is traded' with the possible consequence of 'subsidy races'.

Referring to tax competition, which is probably the one of the commonest examples of locational competition, Schön (1999: 919) highlights that we should talk of *unfair* tax competition in some cases. Referring to the Council Code of Conduct on Harmful Tax competition (1999) and the OECD Survey on Harmful Tax Competition (1999), he notes two elements of the problem, first when the tax does not reflect the true balance between taxes and public services, and secondly when a foreign investor is influenced to invest capital abroad without having to dispense with public services of high quality at home.

What becomes crucial in these cases is to determine whether the 'harmful tax practice' can *also* amount to a subsidy. If there is a preferential regime for foreign companies (ie derogatory and selective), there are good grounds for concluding so. [713] With respect to the possible distortion created by these practices, OECD (1998) clearly considers that a tax incentive which discriminate in favour of foreign companies 'distorts the allocation of resources'. [714]

Clearly, it is very difficult to provide an answer about whether location competition can cause distortion of competition. We attempt to suggest some conclusions.

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[712] OECD (2001: 174) where the Commission raises its opposition; Evans (1997: 82 and 85) who refer to Advocate General Darmon in Case 248/84 *Germany* v *Commission*, page 4031 and to Case 730/79 *Philip Morris*.

[713] Schön (1999: 935).

[714] Reference should be made to the 'Primarolo Group Report' (1999) which prompted the Commission to initiate in July 2001 a large-scale State aid investigation, concerning 15 tax provisions in 12 different Member States (for a review see Pinto (2003: 166-190)). Probably the most known dispute is that on the Belgian co-ordination centres which provided special tax incentives for certain types of financing activities conducted through one of this centres. At the end of June 2006, the Court produced two decisions on these centres in Case Joined Cases C-182/03 and C-217/03 *Belgium and Forum 187* v *Commission*, and Case C-399/03 *Commission* v *Council*. For an analysis

First, a certain degree of competition between Member States and regions is an inevitable consequence of the idea of trade liberalization itself. Factor mobility, particularly in terms of capital and establishment, should depend on the better conditions offered by the various jurisdiction. Further, the idea that a certain amount of competition between regions may represent a factor of change and be efficiency-enhancing for all has certainly some force.

Secondly, it seems equally uncontroversial that there are less reasons to object to the attractiveness which one jurisdiction derives from its *general* tax, labour, environmental regulatory framework.

Thirdly, specific measures (in the sense of both exceptional and non-generally available) makes things woollier as the potentials for distortions are higher.

Fourthly, what emerges from the various positions seems that, legally speaking, the ground of contention concerns substantially the *conditions* (non-discrimination; certain equality in resource endowments among the regions; non-cumulation of benefits) which should be present for locational competition to produce its benefits and not being distortive. It is indeed at this level that subsidy and State aid regulation, and in particular their competitive assessment, should play their role.

### b) Offset of regional location costs

The analysis now focuses on a case which is partly similar to the previous one. There are though two main differences which distinguish the offset cases from those examined above and which justify a separate treatment. The first is that in the cases where the offset of location costs is put forward there is a specific reference to a disadvantage. Consequently, at least in principle, the amount of the subsidy is merely limited to compensating these costs.

The question is whether financial compensation that *merely* compensates the *costs* for locating in a disadvantaged or, in any event, less attractive area, can distort competition. In other words, assuming that there is an advantage, and this advantage is specific, does the measure also produce a distortion? Using the definition of distortion of competition formulated above, does this measure

produce a significant impact on the costs of the recipient so as to alter its relationship with its competitors?

Some argue that, insofar as the subsidy merely compensates the cost for relocating, there would be no distortion. [715] Benitah (2001: 254) suggests that this is an example of a sophisticated approach to the concept of distortion, and that no distortion should be found.

Goetz, Granet and Shwartz (1986: 23) are more specific. There is no problem only if the subsidy covers fixed costs and, crucially, is no related to production (this would be the case if variable costs were covered).

Evans (1997: 83) is more sceptical. He begins underling that 'in most cases it is doubtful whether the disadvantages of an area can be quantified with sufficient accuracy to fix aid at a level which exactly competes for them'. He then pragmatically adds that '[i]n practice, regional aid is usually set by Member States at so high a level that it provides firms with a positive financial inducement to locate and invest in certain areas'.

These two arguments - the difficulty of quantification (of the disadvantage > cost > subsidy) and the need for amounts higher than mere cost offset to produce an incentive - seem to be crucial. The writer would also refer to another, already highlighted, difficulty, that of determining and distinguishing costs.

All these uncertainties seem to lead towards a more negative attitude towards the alleged non-distorting effect of this type of subsidy. In a word, although this may be argued in principle, this conclusion seems to be more difficult to reach in practice.

In the presence of so many uncertainties, there is one fundamental and more general doubt.

If accepted, this reasoning – there is no distortion because we merely have a compensation of a cost/disadvantage - may be extended to many other interventions.

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[715] Beviglia-Zampetti (1996: note 85); Benitah (2001: 254); Jackson (1997: 298-299).

Crucially, this would ultimately risk conflating scope and justification, a recurring theme which raises legal and political concerns. This may be better appreciated if reference is made to the counterfactual of the competitive assessment outlined above, which is the situation before the subsidy, and to the interplay between negative and positive effects, and the relevant cost/benefit analysis examined below.

### c) Consumer welfare: subsidies or competition?

It is sometimes intriguingly advanced that, inasmuch as they result in the availability of cheaper products or services, subsidies are beneficial to consumers.

In the context of countervailing duty actions, it is thus argued that from the perspective of the importing country the import of subsidized goods would be beneficial. [716] Truly, these may create some difficulty for the competing domestic industry but a comprehensive welfare analysis (ie an analysis considering the benefits and the costs for all stakeholders) would lead to conclude that the overall net effect for the importing country is positive, particularly if the benefits to consumers, which are in the position to buy cheaper products, are considered. Accordingly, levying a countervailing duty on imported subsidised products would simply mean imposing a higher price on consumers. With a powerful image, it is thus often suggested that what the importing country should do is simply to send a 'thank you note' to the embassy of the government of the exporting country for the windfall received by its consumers.

It seems however that the radicalism of this argument is mainly justified by its context, and in particular by the criticism of unilateral re-actions. In other words, the whole argumentation is deployed to reject the soundness of countervailing duties (which, far from eradicating the problem of subsidies, would introduce new distortions in the market and tensions in the political and diplomatic sphere). There is indeed some agreement that from a more general, one would say global, perspective, subsidies may be distorting and should be regulated.

The writer's position focuses on the centrality of the process of competition.

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[716] See, eg, Sykes (1989: 210 et seq); id (1997); Barcelo (1977); Trebilcock and Howse (2005: 283)

The benefit of consumers should not be *exclusively* assessed on a short term basis - on the fact that they may immediately obtain goods at a cheaper price. The development of competition in the medium, and indeed longer term, is also, if not more, significant. [717]

In this regard, it is interesting to note that a similar distinction between short and long term consideration has come out also in the context of the so-called 'essential facility' debate, and the relevant dilemma involving protection of innovation, property and competition. At paragraph 56 of the landmark Opinion in the *Oscar Bronner* case, Advocate General Jacobs warned about focussing too much on the benefits that a short term solution may seem to yield.

Returning to our analysis on subsidized products and consumers' benefits, we cannot forget that, in most of the cases, the availability of cheaper products or services is just a *perverse concomitant* of the distortion of the *competitive process.*

According to economic theory, only competition can substantially and lastly deliver benefits to consumers. It is the process of competition that is ultimately capable of yielding benefits to consumers in terms of more, better and cheaper products and services. This consideration seems to support our interpretation whereby subsidies should be prohibited whenever they interfere with competition, that is when they bring about an impact on competitors that are more efficient than the recipients.

To put it in another words, *subsidized* competition cannot be equalled to competition *on the merits.*

The substance of this point is fundamentally accepted also by some proponents of the 'consumer argument' above when they note that countervailing duties may be acceptable in two circumstances: when the subsidy is used as an instrument of predatory pricing and when the subsidy is demonstrably causing serious injury to competing domestic producers in the importing country. [718]

Now, it seems that both cases may well be construed with reference to the competitive assessment suggested above. Whenever the subsidy affects the cost/revenue structure of the recipient and thereby affects substantially the position

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[717] See Whish (2003: Chapter 1).
[718] See Matsushita, Schoenbaum, Mavroidis (2003: 262).

of competitors the need for some form of response (not necessarily a countervailing duty) should be considered.

Finally, the proponents of this radical position risk emptying the subsidy regulation of any distinct meaning and purpose, substantially equalling it to a safeguard discipline.

The requirement to prove an injury to the domestic industry is not explained in terms of economic distortion but is justified in political terms, and in particular with the public choice theory. [719] Accordingly, it would operate as a buffer mechanism introduced to protect the interest of the well-organised domestic industry (as opposed to the diffuse interest of consumers) and would thus bring the subsidy discipline in line with a safeguard measure.

The next step of this reasoning is easily predictable. By draining the injury test of any justification in terms of economic and distortion analysis, and by highlighting its buffering function, the substantial equation to a safeguard discipline is inevitable. Some thus suggest dropping the injury requirement altogether and/or reinforcing the use of safeguards, as the most natural instrument to deal with adjustment problems of the importing country.

In the writer's view this is a bit over the top.

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[719] Sykes (1997).

# 2. Justifications

## About market and government failures, precision and predictability

Subsidies are ambivalent because they may produce different effects, negative (ie distortions of competition) and positive (ie pursue market failures or other legitimate socio-economic objectives). Moreover, the resulting net effect may be uncertain as these effects are indeed difficult to disentangle and to balance with each other. In some cases, it may even be argued that the measure is not a *distortion* but rather as a *correction* of a previously existing distortion.

The crucial idea is however that the market does not always deliver desirable or acceptable outcomes. This may be explained in terms of inefficiency or more simply of injustice.

In these cases, the government intervenes to tackle the imperfection of the market. Various instruments may be used to reach these objectives, and public subsidies are amongst them. [720] The choice of the instrument, and its design, are important, and at this level economics may play an important role.

However, this area is *inherently normative*, ie it is the place where political and policy decisions are made. This is particularly evident with respect to equity problems. Economists are more concerned about efficiency, ie about 'making the cake bigger'. It is policy makers that are concerned about problems of inequality, ie about 'sharing the cake fairly'.

Market failure is not a clear concept. There are different taxonomies among economists. One of the most accredited is that of Stiglitz (2000: chapter 4) who lists six basic market failures, ie imperfect competition, public goods (such as *some* infrastructures and services), externalities (which can be divided into negative ones – such as pollution - and positive ones – such as research and development), incomplete markets (capital markets), imperfect information, unemployment and other macroeconomic disturbances (such as inflation and disequilibrium).

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[720] Schwartz and Harper (1972); Barcelo (1977).

Sometimes, all these forms of imperfection are summarized into what are seen as the two main categories: public goods and externalities.

Stiglitz (2000: 86 et seq) also refers to two other categories that, strictly speaking, cannot be explained in terms of inefficiency of the market but rather inequity, that is redistribution and merit goods (such as culture).

It should be underlined that, in reality, market failures are not mutually exclusive. We may have situations where the market does not function for more than one reason. Further, in some cases, we have a mix of efficiency/equity problems.

We have already said that economics may play a role in detecting a market failure and in indicating the most efficient instrument to tackle it. However, although this may seem easy and straightforward in principle, it may become very woolly at the practical level.

The fact is that it is sometimes very difficult to identify *the* problem (as said there may be more than one imperfection in the market). Further, it may be difficult to *quantify* it. Thirdly, and most importantly from the perspective of the justification of subsidies, it may be difficult to *quantify* the amount of aid which is necessary to correct market failures. Fourthly, this quantification problem makes it difficult to balance the negative and positive effects of the measure to eventually make a decision on whether it should be legitimate or not. Finally, it should not be underestimated the risk of regulatory capture by rent-seeking lobbies.

In a recent conference on the current State aid reform, Professor Ehlermann (2005) underlined this problem and referred to the conclusion of a roundtable held in 1999 at the European University Institute in Florence. [721] It is worth repeating fully 'one of the most disappointing conclusions' of that symposium:

> The general feeling among participants was that economists are not particularly well-equipped to help the Commission to discipline State aids through general guidelines, although their assistance in improving analytical tools for dealing with individual cases can be valuable.

[721] The proceedings of this interesting conference are fully included in Ehlermann and Everson (2001)

What immediately hits the eye of the writer is the distinction among *guidelines* and *case analysis*. This seems indeed to be the core of the problems when economists and lawyers talk with each other. Lawyers want to have *rules*, ie benchmarks which can ideally be applied repeatedly to various similar cases in the future. Economists seems to be more concerned with the specificities of each case which would require a *case by case analysis* and the use of complex analytical tools (which can be contrasted to the idea of guidelines).

One of the big challenges is to combine the two perspectives. The effort, which underlies the SAAP in the EC, is the attempt to combine the *predictability* and *certainty* of legal rules with the *soundness* of economic concepts and tools.

A very nice exposition of this effort has come from the former Chief Economist at the European Commission and two of his colleagues which produced an accessible but solid paper which attempts to show the role that economics should play in the new 'effects-based' approach to State aid and its regulation. [722]

Interestingly, Friederiszick, Röller and Verouden (2006) seem essentially to recognise the point that has emerged a few years ago in the hills around Florence, ie the contrast between guidelines and case-by-case analysis. In their words, the 'architecture of state aid' should therefore denoted by 'precision' (which their effects-based balancing test should be able to achieve) and 'predictability' (which is the concern for legal certainty).

What they, therefore, suggest is not to abandon the guidelines but to design them in a proper way.

Their suggestions are very interesting – from a lawyer's perspective – and deserve attention. As they expressly state

> an economic approach does not mean a full assessment in all cases. The obvious solution – like in all other areas of competition policy, such as mergers and antitrust – has to be a sensible combination of safe harbour thresholds and prohibition thresholds and a more complete economic assessment for those cases (limited in number) which fall in between these two thresholds. [723]

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[722] Friederiszick, Röller and Verouden (2006).
[723] Friederiszick, Röller and Verouden (2006: 50).

The safe-harbour thresholds should be constituted by the cases which are *de minimis* and by those 'for which one is confident that no substantial distortions of competition and effects on trade will arise. These would be block-exempted'. [724]

At the other end of the spectrum we would have *per se* prohibitions.

The most interesting area however is the intermediate one. Guidelines should be drafted and they

> [s]hould outline the analytical framework applied for an effects based, economic assessment of the individual measures. Within these guidelines, the Commission could make use of "soft" safe harbour regions, indicating, for instance, that below certain aid intensity thresholds or when certain specific criteria are met, the Commission would be *unlikely* to take a negative decision on the aid measure. [725]

The writer's understanding is however that, at this intermediate level, a *balancing* approach, which is based on an analytical analysis of the case, would takes place. And, significantly, the burden of proof should lie on the Member State. It should therefore prove that there is a market failure or another objective of common interest, that the aid measure is an appropriate instrument to tackle the problem, that it produces the desired incentive effect, that its amount is necessary, and, eventually, that the overall balance is that the distortions on competition and the effect on trade are limited. [726]

In other words, it is necessary to establish that the subsidy, and *that* subsidy (in its form and effects), is an 'optimal intervention' [727] and properly consider the *government failures*. Apart from the regulatory capture problem, common experience tells that, in many cases, public administrations are, for various reasons, inefficient. This might have an impact on the effectiveness of the subsidy as a tool to remedy the market failure.

The writer believes that this theoretical framework goes in the right direction.

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[724] Ibid.
[725] Ibid.
[726] For a full exposition see Friederiszick, Röller and Verouden (2006: 37 et seq).
[727] Low (2001: 107).

Further - hypothetically and ideally - it could be applied not only in the EC but also in a wider organization such as the WTO. Two main issues would have to be tackled in this regard: first, an institutional/procedural problem (that of a centralized and possibly preventive control of subsidies) and, secondly, from a more substantive perspective, the introduction of rules expressly acknowledging the positive effects produced by subsidies.

## Is there any distortion in the first place?

An intriguing issue, with important conceptual and practical implications, is whether it is really possible to talk about a distortion of competition when the measure addresses and corrects a market failure.

Pelkmans (2001: 242) has for example argued that 'if the aid is paid to overcome a market failure, it is not distortive – indeed, it is to restore efficiency'. Similarly, after explaining the second-best theory, Evans (1997: 80) more clearly suggests that

> since competition requires efficient allocation of resources, aid which merely corrects inefficient allocation associated with market failure may not be regarded as distorting competition

There is also another way of looking at it. Unlike the 'first-best' theory which presupposes the possibility of the removal of the *only* existing distortion in the market to achieve full-efficiency, the 'second-best' theory says that, if this is not possible, because there are more than one distortions, the solution is to introduce a new *distortions* to offset the *distortions* that already exist. [728]

Some illumination on this debate emerges from Nichte and Heidhues (2005: 109) who claim that the issue depends on the concepts of welfare and market failure – narrow or broad - that are adopted.

Following Stiglitz (2000: chapter 11), and his idea of cost-benefit analysis, Friederiszick, Röller and Verouden (2006: 37-38) suggest that the idea of separating

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[728] Begg, Fisher, Dornbush (1997: 247).

negative and positive elements, and assessing them with the said balancing exercise at the level of justification is a 'more practical approach'. The writer would also add that this is also in line with the separation between scope and justification that has been repeatedly advocated in this work.

The traditional approach is to separate the various effects and leave to the Commission to carry out the necessary full and complex assessment of the situation. Quite similarly, in the WTO we usually have a rather limited concept of net subsidy and we have (*rectius*: used to have) a specific category of subsidies that are not actionable and where the legitimate objectives of subsidies could be considered.

Evans (1997: 80 and 83) has also underlined that, from a practical point of view, it is often difficult to determine whether an aid simply compensates a distortion. As seen above, for example, it is not often easy to determine whether a regional aid merely offset a disadvantage (and thus can be regarded as non-distorting) or rather creates distortions.

## Correction across the border or political trade-off?

There is a final point which should be addressed before briefly reviewing the main features of the two legal systems.

It may well be that the subsidy pursue a legitimate objective, by resolving a market failure or a situation of inequity, in the subsidising country. The crucial issue from the perspective of an international discipline of subsidies however is. What about the welfare and/or interest of the other countries? In particular, while producing positive effects at the local/national level, this measure may still produce significant negative externalities across the border.

To be true, it is necessary to distinguish. In some cases, it is possible to identify measures that produce also positive effects, or externalities, across the border. A clear example comes from the EC where, in the case of regional aid, a distinction is made between those measures that relieve a disadvantage which is essentially considered national (and hence assessed against a national benchmark) and those

that tackle a problem that is considered of Community interest (and hence assessed against a Community benchmark).

The fact remains that, at least in a direct and short term perspective, it may well be that the beneficial effect will be produce only at a local level and the distortions also at an international level. This asymmetry may well be accepted by the Members as a trade-off. In other words, the countries can consider that, if in some cases they lose from the game, in other cases the win.

## 3. Control and remedies

On the premiss that the measure at hand produces an externality across the border, the final step of this section is to consider in brief – by mainly providing a list - the possible forms of control of and remedies against subsidies.

### Countervailing duties

This is one of oldest remedies against subsidies. It focuses on the perspective of the importing country that sees its domestic industry somewhat damaged by the subsidised imports. To countervail this injury it may impose a duty on the imported products which should offset the undue advantage.

Despite being very popular with importing governments and their constituencies, ie the domestic industries, this type of reaction is increasingly criticized with various economic and political arguments. [729]

### Countervailing subsidies

Another possibility, which again is very old but still popular, is to directly subsidize the aggrieved domestic industry to level the playing field. Although Meicklejohn (1999: 31) argued that they are a better, ie more efficient, alternative than countervailing duties, [730] the big political and legal risk is that they could lead to a 'subsidy war'.

For this reason, at a legal level, they seems to be generally outlawed in both EC and WTO. This is a consequence of the rule of law and of the rejection of the principle of reciprocity. The Court in *Steinicke* made it clear that the grant of an aid cannot be justified by the fact that similar subsidies are granted by other Member States. [731] A similar principle has been soon affirmed also in the GATT, in the *DISC* Panel. [732]

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[729] A comprehensive exposition of the arguments in favour and against countervailing duties can be found in Trebilcock and Howse (2005: 282-285).
[730] See also OECD (2001: 30, second paragraph).
[731] Case 78/76, paragraph 24.
[732] At paragraph 79.

Both systems seem to permit only certain remedies. In the WTO this is clearly enshrined in Article 32.1 SCM (which reaffirms the rule of law by providing that 'no specific action against a subsidy of another Member can be taken except in accordance with the provision of GATT 1994, as interpreted in this Agreement) and has been fully upheld in the *US – Byrd* dispute.

## Multilateral obligations and centralized controls

One of the most interesting ways to deal with public subsidies which cause externalities across the board is to establish multilateral obligations and to set up a form of centralized control.

The EC and WTO are two good, different examples of this way.

It has indeed been argued in various quarter that the EC regime of State aid control represents a model that should be followed globally.

Echoing the settlement adopted in the EC, Barcelo (1977: 838) suggested the

> need for a permanent GATT panel or working party to review domestic production subsidies for their efficiency effects, with GATT approval or disapproval turning on the outcome. [733]

The argument underpinning this suggestion is that a sound welfare analysis would require i) a larger perspective than a national one, ii) a case-by-case analysis, iii) a supranational authority. [734]

The same proponents of this model however recognize the difficulties of transposing it at an international level. Barcelo (1977: 838) for example shows that the proposed assessment would be difficult, especially when we are confronted with a non-efficiency objective. Here it is necessary to balance the prerogatives of sovereignty with economic interdependence.

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[733] For a similar suggestion see also Trebilcock and Howse (2005: 290-291).
[734] Barcelo (1977: 838).

As we will see, this is what in principle occurs in the EC. Low (2001: 115) noted that this closer examination of the effects of subsidies would be difficult in the WTO.

In other words, by subjecting to these obligations and centralised controls, Members accept the grant of aid or subsidies that *may* be detrimental to their interest. At the same time, however, they will themselves benefit from the same standard of assessment when they grant aid. This trade-off is the essence of the settlement. This will not however exclude controversies and clashes between the various stakeholders in the various cases.

## Negotiated reductions

Another alternative is that of negotiated reductions of subsidies. This is the model followed by the Agreement on Agriculture.

A final gloss: all the previous methods of control/remedy are not necessarily mutually exclusive. We may therefore have systems which, albeit in different forms and degree, variously combine them. Their separate treatment has been required for the sake of conceptual clarity.

## III. The current legal framework: a brief critical review

In this final paragraph, taking stock of the previous analysis, we attempt to analyse the main treats emerging from the current legal disciplines of subsidies and State aids and assess them. We to this through cases which we consider exemplary.

### 1. Negative effects

With respect to the negative effects of the subsidy, it seems that both systems have often relied more on a 'simple' or 'simplified' idea rather than on a 'sophisticated' one.

We can provide two examples, one from each system.

#### EC law: distortion of competition and effect on trade

In the EC, for long time the paradigm of the assessment of the distortion of competition and effect on trade has been set by the *Philip Morris* case. [735] This decision merely requires the strengthening of 'the position of [the recipient] undertaking compared with other undertakings competing in intra-Community trade' to prove a distortion and an effect on trade. [736] Now, by definition, any form of financial assistance will strengthen the financial position of its beneficiary, and its position *relative* to its competitors that do not receive any money. This does necessarily mean that a distortion of competition in the sense explained above - impact on cost/revenue structure which damages more efficient competitors - has occurred.

A corollary to this statement was that a market analysis, and the usual tools deployed for the other competition rules (Articles 81 and 82 EC) was not necessary.

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[735] Case 730/79.

[736] It is interesting to note that even stricter positions were present in the EC. In 1981, in its Annual Report on Competition Policy, the Commission essentially rejected the autonomy of the requirement of distortion of competition holding that any aid is liable to distort competition and hence it is not necessary to prove the effects (see point 176). A similar position was taken by Advocate General Capotorti in the *Philip Morris* case where he said that a distortion of competition is presumed to take place.

Still, the Commission was to provide a statement of reasons of its determination of distortion and effect on trade, but, frankly, the standard seemed to be quite low. [737]

Another consequence, which is still resisting, was the rejection of any *de minimis* threshold. [738] Although it may be correct that, in presence of certain market conditions, even a small amount of aid may be liable to distort competition, this cannot be the rule, not even a presumption.

Things seem to be partly changing now. First, there has been an increasing criticism (sometimes not limited to State aid law) that the Commission was not sufficiently concerned of the economics of the case. Secondly, the trend – which is strongly supported by the Commission with the SAAP and also by other National Competition Authorities [739] – is towards a more effect-based, ie more economic approach to establish the possible distortions on competition and the effect on trade.

## WTO: causality in the injury test

If we now move to the WTO, we substantially note a similar situation, ie the adoption of a simple idea of distortion.

The most paradigmatic example is given by the uncertainties still surrounding the injury test, and in particular the requirement of causality.

Before commenting, it may be useful to briefly report the text of the relevant provision, Article 15 SCM and, in particular, paragraphs 1, 2, 4 and 5 thereof read

> a determination of injury ... shall be based on positive evidence and involve an objective examination of both (a) the volume of the subsidised imports and the effect of the subsidised imports on prices in the domestic market for like products and (b) the consequent impact of these imports on the domestic producers of such products.
>
> With regard to the volume of subsidised imports, the investigating authorities shall consider whether there has been a significant increase in subsidised imports, either in absolute terms or relative to production or consumption in the

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[737] Cases 296 and 318/82 *Leeuwarder*.
[738] See above.
[739] See OFT (2005); OFT (2004).

importing Member. With regard to the effect of the subsidised imports on prices, the investigating authorities shall consider whether there has been a significant price undercutting by the subsidised imports as compared with the price of a like product of the importing Member, or whether the effect of such imports is otherwise to depress prices to a significant degree or to prevent price increases, which otherwise would have occurred, to a significant degree. No one or several of these factors can necessarily give decisive guidance.

The examination of the impact of the subsidised imports on the domestic industry shall include an evaluation of all relevant economic factors and indices having a bearing on the state of the industry, including actual and potential decline in output, sales, market share, profits, productivity, return on investments, or utilisation of capacity; factors affecting domestic prices; actual and potential negative effects on cash flow, inventories, employment; wages, growth, ability to raise capital or investments and, in the case of agriculture, whether there has been an increased burden on government support programmes. This list is not exhaustive, nor can one or several of these factors necessarily give decisive guidance.

It must be demonstrated that the subsidised imports are, through the effects [as set forth in paragraphs 15.2 and 15.4][740] of subsidies, causing injury within the meaning of this Agreement. The demonstration of a causal relationship between the subsidised imports and the injury to the domestic industry shall be based on an examination of all relevant evidence before the authorities. The authorities shall also examine any known factors other than the subsidised imports which at the same time are injuring the domestic industry, and injuries caused by these other factors must not be attributed to the subsidised imports. Factors which may be relevant in this respect include, inter alia, the volumes and prices of non-subsidised imports of the product in question, contraction in demand or changes in the patterns of consumption, trade restrictive practices of and competition between the foreign and domestic producers, developments in technology and the export performance and productivity of the domestic industry.

Despite its high sophistication, the language of this provision is indeterminate.

In particular, serious problems have arisen in the interpretation of the causation standard. It has been noted that 'there is no precise definition in the Uruguay Round Agreement of "cause", beyond a list of factors that may be examined, leaving the appropriate standard to the discretion of the investigating authorities'. [741]

Benitah (2001: 281) underlines that such indeterminacy depends on the fact that 'each provision is drafted in such a way as to refer to another and this interrelation and interdependency forms an almost closed loop'. Indeed, all relevant provisions

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[740] The text between brackets appears in a footnote in the original text.
[741] Trebilcock and Howse (2005: 380). Cf also Benitah (2001: 281 et seq.)

(Article VI GATT [742] and Article 15, paragraphs 1, 2, 4 and 5) attribute a language of causality alternatively to *subsidised imports* or to *subsidisation.*

The most difficult issue is raised by the link between 'effects of the subsidy' and 'paragraphs 2 and 4' made by footnote 47 in Article 15:5 SCM.

Two constructions of the causation standard seem possible.

It may well be that a determination of injury to the domestic industry is made even though the adverse effects do not depend on the subsidisation but rather on imports' competition. Support of this reading has been found in the Panel Report in the *Atlantic salmon* dispute. Applying the virtually identical provisions of the Tokyo Subsidy Code, the Panel noted that the expression 'through the effects of subsidies' refers to the effects set forth in the paragraphs on volume increase, price effects and impact on industry. On this basis, it is then concluded that that expression does not require proof that subsidisation is the cause of the injury, but merely that the subsidised imports are the cause. [743]

However, 'injury to the domestic industry cannot be equated to distortion of competition. Injury to competitors is not the same as injury to competition. '[744] Indeed situations can be imagined where subsidised imports prove popular with purchasers, and therefore injure the domestic industry, for reasons other than price, for example quality. [745]

Beviglia Zampetti (1996) has thus suggested that, maybe through a progressive judicial interpretation, the injury test (as well as the other two types of adverse effects provided for in Article 5 SCM: serious prejudice and nullification and impairment of benefits) should be construed so as to guarantee what is seen as the underlying aim of the GATT/WTO system, the safeguarding of 'normal competition'.

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[742] Article VI:3 GATT reads that '[n]o contracting party shall levy any ... countervailing duty on the importation of any product ... unless it determines that the effect of .... subsidisation ... is such as to cause or threaten material injury to an established domestic industry'.
[743] Cf GATT Panel Report, *US - Imposition of countervailing duties on imports of fresh and chilled Atlantic salmon from Norway*('Atlantic salmon'), SCM/153, adopted on 28 April 1994, paragraphs 328 et seq.
[744] Beviglia Zampetti (1995: 23).
[745] See McGovern (1995: paragraph 12.415).

Despite the difficulties in defining the purpose of the WTO system, and of subsidy rules in particular, this 'competition-oriented' interpretation seems to be in line with the wording and purpose of Article 15 SCM.

The first sentence of Article 15:5 SCM expressly sets out the object of the determination and, in doing so, it defines the relationship between 'subsidised imports' and 'subsidisation'. According to that passage, 'it must be demonstrated that the subsidised imports are, *through the effects of subsidies*, causing injury within the meaning of this Agreement'. [746] It is indeed reasonable to require such causal link, as the object of the SCM Agreement is to regulate subsidies and responses to them. With respect to the latter, if there is no subsidy then there cannot possibly be any countervailing duty. [747] Article 21.1 SCM is clear on this point expressly stating that 'a countervailing duty shall remain in force only as long as and to the extent necessary to counteract *subsidisation which is causing injury*.' [748]

If therefore the injury depends on factors other than subsidisation no determination of injury should be made. Article 15.5 SCM accordingly requires the examination of 'any known factors other than the subsidised imports which at the same time are injuring the domestic industry' and makes it clear that 'the injuries caused by these other factors must not be attributed to the subsidised imports'. Among these factors, 'competition between the foreign and domestic producers' is also included.

This 'competition-oriented' interpretation would also contribute to safeguarding the system's coherence. Indeed, Article VI GATT and the SCM Agreement concern *subsidies* and responses to *subsidised* imports. As has already been argued above, the need to provide, under certain (exceptional) circumstances, 'import relief' to the domestic industry should be addressed by safeguard mechanisms, [749] and not by subsidy rules.

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[746] Art 15.5, first sentence SCM (emphasis added). Cf also Art 19.1 SCM.
[747] Cf Panel Report, *US – Carbon Steel II*, paragraph 6.48 et seq.
[748] Emphasis added. Cf also Article VI:3 GATT and footnote 36 to Article 10 SCM which read that countervailing duties are levied for the purpose of offsetting any subsidy.
[749] Article XIX GATT and the Agreement on Safeguards.

## Simple idea of distortion in EC and WTO: a tentative explanation

It can be argued that the endorsement of a simple idea of distortion in the EC which is fully consistent with the fact that the definition of State aid in Article 87(1) EC was created in the context of the promotion of a common market. [750] In other words, a simplified idea of distortion is easy to prove and, by catching many measures within its net, may fully contribute to the *integrationist* aim of the common market.

The use of a simple idea of distortion may find a different - and indeed an *opposite* - justification in the context of the GATT/WTO.

A simplified concept of distortion could be in line with allegations based on not well defined ideas of *fair* competition since the relevant benchmark (what is fair? What is unfair?) is difficult to identify. A particularly low evidentiary threshold would serve the objective to protect domestic industry injured by foreign imports. The inherent risk, however, is that a simple idea of distortion could end up being a particularly powerful tool in protectionist hands. This is particularly clear in the context of unilateral actions finalised at the imposition of countervailing duties.

The conclusion. If the accepted objective of both systems is to address distortions of international competition (and this can be inferred also from the very general statements of the WTO disputes), the most appropriate approach to the definition of the trade-impact standards in the sophisticated view of distortion which requires a distortion of competition based on a specific impact on the cost/revenue structure.

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[750] See the Commission' statements in OECD (2001: 173).

## 3. Positive effects

Here the picture becomes more complicated, from both the substantive and institutional/procedural point of view. As in the previous section, the writer will merely sketch some issues which are considered as particularly significant.

### EC: from general clauses to block exemption, from discretion to precision and predictability

The justifications of State aid in the EC Treaty are constituted with general clauses. The monopoly for their application has been for the Commission which has always been considered to enjoy a wide discretion in its complex economic and political assessment. In terms of normative development, the trend can be described as follows. We passed from general clauses to policy definition, to policy consolidation in the form of various soft law instruments (guidelines, communications, notices, frameworks, letters), to eventually reach the stage of hard law in the form of 'block exemptions'. This latter stage has also a clear and significant impact on the institutional and procedural aspects. Although it cannot be compared to the modernization of Article 81 EC, it directly, albeit partially, involves national authorities and courts in the application of State aid 'justifications'.

The decentralization trend also concerns other more traditional instruments such as the Commission Decision and the Commission Framework in the area of public service compensation or the, for now draft, frameworks on LASA and LET.

Decentralization and simplification means freeing human and administrative resources which the Commission could more valuably use in its still crucial monopoly in the control of State aid.

Another important trend, which has partly been hinted at already in the previous section, is the increasing 'effect-based' approach towards State aid scrutiny. This sits nicely with our previous defence for a more sophisticated notion of distortion at the level of Article 87(1) EC.

At the moment DG Competition seems to be a powerhouse. In the light of the vision of the SAAP it is putting hands in any area of State aid policy such as

Research and Development and Innovation, Environment, Regional Aid, Rescue and Restructuring, SMEs. Various consultations are launched, draft documents come out. Clearly, this is not the right place for commenting them. What can be said however is that the at least intended *leit motif* which is guiding all these initiatives is to substantially reform in a more transparent, predictable and efficient way State aid control and ultimately the grant of State aid. Whether these exercises are successful or not, only time – and further research – will tell.

## WTO law: the missing limb

Under Article 8 and 11, the former Tokyo Subsidy Code included a broad recognition of the various public policy objectives that Members may wish to pursue through subsidies. [751] As the *US – Carbon Steel I* dispute has shown the legal effect of this recognition was far from clear.

The WTO brought a big advancement. Drawing inspiration from the EC experience introduces a category of non-actionable subsidies. These categories were far more limited than those generally recognized in the Tokyo Subsidy Code but with a substantial difference. There was a (more) developed substantive and (less) developed institutional/procedural discipline.

It may be useful to summarize this discipline. Article 8.2 SCM refers to the following three categories of non-actionable subsidies:

- subsidies for *research* activities conducted by firms or by higher education or research establishments on a contract basis with firms if, in particular, the assistance does not cover more than given amounts depending on whether the activity is of 'industrial research' or 'pre-competitive development', and if it is limited to certain classes of costs;

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751 Article 11 for example mentioned: to eliminate industrial, economic and social disadvantages of specific regions; to facilitate the restructuring, under socially acceptable conditions, of certain sectors, especially where this has become necessary by reason of changes in trade and economic policies, including international agreements resulting in lower barriers to trade; generally to sustain employment and to encourage re-training and change in employment; to encourage research and development programmes, especially in the field of high-technology industries; the implementation of economic programmes and policies to promote the economic and social development of developing countries; redeployment of industry in order to avoid the congestion and environmental problems.

- subsidies in favour of disadvantaged *regions* given pursuant to a general framework of regional development and non-specific within eligible regions provided that the region is clearly definable, it is considered as disadvantaged on the basis of neutral and objective criteria such as income or GDP per capita and the unemployment rate;

- subsidies to promote adaptation of existing facilities to new *environmental* requirements imposed by law and/or regulations which result in greater constraints and financial burden on firms, provided that the assistance is *inter alia* a one-time non-recurring measure, limited to 20% of the cost of adaptation, directly linked to and proportionate to the plan of reduction of nuisances and pollution, and is available to all firms that can adopt the new equipment or production processes.

From a procedural view, Article 8.3 SCM provides that, whenever a subsidy programme falls within one of the previous three categories, it should be notified 'in advance of its implementation' to the Committee. A system of yearly updates of the notifications, including, in particular, information on modification of the subsidy programmes, is also envisaged. Further, upon request of a Member, the Secretariat and the Committee should review the notifications to determine whether the conditions and criteria laid down above have been met.

These subsidies are neither actionable nor countervailable because they serve economic and social objectives of overriding importance.

Nonetheless, Article 9 provides that if a subsidy programme complying with the criteria above (and hence being in principle 'non-actionable') is causing *'serious* adverse effects' to the domestic industry of a Member, such as to cause damage that would be difficult to repair, consultations can be requested. If no mutually acceptable solution is reached, the matter is referred to the Committee that could recommend the modification of the programme to remove the effects. It has to be noted that the trade-impact standard under that provision is stricter than that provided for 'actionable subsidies' ('serious adverse effects' vs 'adverse effects').

Together with the categories of prohibited and actionable subsidies, this category was an important limb of the SCM Agreement. This category however lapsed in the

year 2000 as it was not possible to reach a consensus to extend their application according to Article 31, [752] mainly because of developing countries' concerns about the alleged imbalance of those provisions in favour of developed countries[753]. It is regrettable that those provisions could not be extended, even for a limited period of time, to allow further experience on their application to be gained and consideration of possible amendments to address developing countries' concerns. The risk of letting those provisions lapse was however underlined as, after that, it would have been extremely difficult 'to resurrect the key concept of non-actionability' and, in any event, to start again from scratch. [754]

This was a good prediction. The current Rules Negotiations in the context of the Doha Round have produced little discussion with respect to the issue of subsidy. We can find just few rare submissions concerning the possibility of resurrecting this category, particularly from developing countries. Indeed, the Doha Ministerial Conference expressly noted

> ... of the proposal to treat measures implemented by developing countries with a view to achieving legitimate development goals, such as regional growth, technology research and development funding, production diversification and development and implementation of environmentally sound methods of production as non-actionable subsidies, and agrees that this issue be addressed in accordance with paragraph 13 below. During the course of the negotiations, Members are urged to exercise due restraint with respect to challenging such measures. [755]

In the next chapter, it will be seen that some proposals in this sense have also been put forward in the Council for Trade in Services.

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[752] 'The provisions of paragraph 1 of Article 6 and the provisions of Article 8 and Article 9 shall apply for a period of five years, beginning with the date of entry into force of the WTO Agreement. Not later than 180 days before the end of this period, the Committee shall review the operation of those provisions, with a view to determining whether to extend their application, either as presently drafted or in a modified form, for a further period'.

[753] See the minutes of the regular meeting of the Committee on Subsidies and Countervailing Measures held on 1-2 November 1999 (G/SCM/M/24) and of the special meeting held on 20 December 1999 (G/SCM/M/22).

[754] The representative of the Canadian government warned about the risk of 'throwing the baby out with the bath water'.

[755] See Implementation-Related Issues and Concerns Decision, paragraph 10.2.

It remains to be seen, however, whether Canada's prediction was a good one. This is true at least for now, since, at the time of writing, the negotiations have been suspended. [756]

## A parallel between EC and WTO law

Any parallel is necessarily based on the assumption (or condition) that some form of justification rules will be reintroduced in the future in the WTO.

What we can do now is simply to draw a comparison with the former 'non-actionable' category.

The first interesting remark is that, very much like for the definition, the WTO seems to have started very fast. It has been said that there was a clear inspiration from the EC regime of justifications. The fact remains that, like for the definition, the three categories of non-actionable subsidies, far from being general clauses, were fairly sophisticated. This probably depended also on the procedural/institutional arrangement. The kind of review/control exercised in the WTO was certainly not comparable to that of the EC in terms of transfer of powers. To put it bluntly, the Committee on Subsidies was not the Commission. Another important element of differentiation is given by the particular constitutional arrangement in the EC. It has been seen that EC law has direct effect into the national systems. This means that national courts actively participate and cooperate with the Commission in discharging its duty of control. The division of duties is clear. Whereas national Courts ensure that the procedural obligations of notification and non-implementation provided for under Article 87(3) EC are respected, the Commission devotes its energies to look at the substance of the measure to determine whether they are compatible or not with the common market.

Another noticeable difference is given by the limited categories of justifications provided for in the SCM Agreement.

That said, there were also many similarities which seemed to take stock from the suggestions of those commentators that, already in the 1970s, thought that, despite

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[756] An official press release from the WTO announced the stop of the negotiations on the 24th July 2006.

difficulties and possible adjustments, the EC regime of State aid control was a model to follow also at the international level.

The fact remains that the WTO system of subsidy control has now a missing limb.

## IV. Conclusive recommendations

Some conclusive remarks can be formulated. We will expressly draw inspiration from both sections of this chapter, the first on the economics and politics of subsidies, the second on the legal rules. These remarks are sometimes formulated in terms of recommendation. Taking into account of the different level/purpose of integration of the two legal systems, they are expressed in terms of feasibility, commencing from the easier to implement.

1. The first recommendation is that both systems should adopt more clearly a sophisticated view of distortion in all their trade-impact tests. This would require a comprehensive analysis that a distortion of competition has actually occurred as a consequence of the State aid or the subsidy. An ancillary suggestion would be that WTO somewhat simplifies the trade-impact standards for actionable subsidies (do we really need three of them?)

2. The second group of recommendations will be divided according to the addressee:

a) Along the lines of a more 'effects-based' approach, the EC should follow the path indicated by the SAAP. With one caveat: that more precision is really combined with predictability. On the one hand this means that the right balance should be found between economics and law. On the other hand, so far, it is not still clear that the hard work of DG Competition in terms of quantity of proposals is a healthy process of re-regulation or more simply of creeping over-regulation.

b) Apart from the clarification of some provisions, this research, with its recognition of the ambivalent role of subsidies, and the leit motif of distinguishing between scope and justification, makes evident that one of the most important step to make in the future is to resurrect the *idea* of non-actionability. The forms and content

may well differ (although our personal tendency would be to expand the former categories to other policy objectives, such as the restructuring of undertakings, and to follow a trend similar to that indicated by the SAAP). What is important is just to revive it.

3. The third set of suggestions, which concern the type of governance of subsidy control, should again be individually addressed to each system:

a) In the EC, it is necessary to continue with the process of codification initiated with the block exemption, and probably to involve national competition authorities further (it should not be forgotten that there are already – at least one – national competition authorities that deal with State aid problems on a day-to-day basis).

b) We would probably make an opposite recommendation to the WTO. Should justifications be re-introduced, it would be necessary to strengthen the system of control and make it more effective, maybe enhancing is authorization function.

4. The fourth recommendation mainly concerns the international dimension and is necessarily to be viewed in a longer perspective. It partly overlaps the previous suggestions:

- reinforcement of justifications

- reinforcement of the multilateral track

- eventual elimination of unilateral remedies

# Chapter 6

# Going back: Few Conclusive Thoughts

The writer is embarrassed for having called this a 'chapter'. It is not.

It is more the recollection of the experience of these years of research in such a challenging area and topic.

'It is an even swap'. It is true. A lot has been learned by comparing two dynamic and sophisticated systems such as the EC and the WTO. The writer has also been lucky enough to do his research in a period of great debate, many disputes and promising changes in the area of public subsidies.

The analysis of EC and WTO law has shown the existence of several similar, if not identical, issues. Indeed this was one of the first methodological steps of the comparative approach, ie to identify two sets of rules that pursue the same function.

Quite remarkably, many similarities in the solutions have been found. At the same time, surprising and important differences have emerged. Each system has its strengths and weaknesses. Each system has to learn something from the other.

All this has provided food for thought, and together with brief wanderings in other non-legal areas, has provided the writer with some ideas and beliefs about some of the characteristics that an international discipline of public subsidies should have (or should not have).

One of the recurring themes has been the idea that – so far as possible - there should be a distinction between what is scope and what is justification. Even economic analysis, with its distinction between costs and benefits, seems to have supported this view.

One – almost intuitive – finding has been the discovery of the expansion of market logic, in a period of increasing liberalization and privatization. But, at the same time, it has emerged that the public interest is still solid there and only needs to find a proper legal accommodation.

Another important finding is the intriguing relationship between law and economics. Sometimes they quarrel with each other but they need each other. They should only understand what is their proper role and the kind of contribution that they can offer towards the same end. The current debate in the EC is very thought-provoking from this perspective. We just need to see the fruits of the harvest.

Another interesting issue, which is worth exploring in the future, is the relationship between subsidy/State aid law and other areas of the law, and in particular the rules of liberalization of trade. The interplay between trade and competition, and trade regulation and competition regulation should be explored further. Many valid scholars have started to follow this path. The writer proposes to do the same in the future.

The comparison between EC and WTO law has also been very stimulating. Again, this is another path of research which is increasingly followed. But it is worth. Despite their differences, the two systems seem somewhat to share the same *DNA*.

Moreover, an almost continuous legal analysis has exposed the writer to the intricacies of the methods of legal interpretation, another (always) topical issue, particularly in the context of two different legal systems.

The final consideration is a recognition of self-limitation. This research does not *fully* correspond to what the writer was proposing to do a few years ago. Many more issues should have been analysed. In this regard, he cannot say to have completely respected the indication of Paul: 'Probe everything!'. A possible justification comes from the Appellate Body and its indication that 'the universe of subsidies is vast'.

However it be, the awareness of this limitation is a further motivation for future research.

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